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Editorial Comment

Parliament Still Has Its Uses

Though Parliament has been in session for several weeks, up to the time when this is written late in February, the diet has been of skim-milk calibre. Whatever cream there may be, in the way of vital information and solid debate concerning public policy, has still to come to the top. Perhaps the budget and some other important items will have appeared by the time this is in print. The earlier debates boil down to little more than a lament, by parliamentarians themselves, to the effect that all the real powers have been usurped by the government through its orders in council and other machinery, in consequence of which Parliament feels like a stranded derelict.

In the light of the ten thousand odd orders in council, and the broad fact that since the commencement of the war no major step appears to have been undertaken via parliamentary decision, one may well sympathize with the new inferiority complex of our supposedly ruling houses. Perhaps it is only just retribution. For the past thirty years the business community has complained about the excess of legislation—the accumulation of statutes of Parliament, of Congress, and of the nine provinces of Canada

and the forty-eight states of the union, at a rate far beyond the capacity of the public to understand them. Thus a senator pointed out, on 5th February, that "when you compare the year's statutes with the orders in council and the orders of the various controllers and boards passed each year, you find the statutes are contained within a very small volume, an inch or two thick, whereas the orders complained of, if bound together, would make a volume ten or twenty times as large." Obviously what has happened is that the work of government has leaped far beyond the capacity of parliament to cope with it.

Yet Parliament has its uses, even under the present cloud. They include the following: A training school for cabinet material; a medium in which shifts in party strength may be revealed, between election dates; a sounding board for public opinion; and an advanced debating society. It is not suggested that these are sufficient to ease the conscience of even the most humble member. They fail to satisfy the minds of those citizens who recall that Britain won the admiration of the world because of its "mother of Parliaments." And they augur poorly for the future of parliament—if direct controls are to survive the war. Truly, this parliament of ours is something that has to be reborn, if it is to escape eclipse.

Government Spokesmen

The sight of an army of public servants making speeches and announcements on government policy, both future and present, is something that would cause any one of our statesmen of former days to turn over in his grave. The tradition was, that a government employee is a purely administrative officer, enforcing the statutes of Parliament and the regulations which have been adopted by order-in-council thereunder. Any plans for the future, contained in the minds of the cabinet or of members of parliament, were a sealed book to him. Any speech made by a public servant under these conditions was hardly worth the hearing.

The establishment of separate boards and commissions for special tasks boosted the status of administrative heads from the view point of public policy. Where a body such as a workmen's compensation board of one of the provinces, or the Board of Railway Commissioners of the Dominion, was empowered to make the regulations, set the rates, and

in fact completely administer an entire field of government, one of its members, or even one of its senior employees, conceivably could make announcements and forecasts concerning his special field without intruding on cabinet responsibility. The mushroom growth of such boards during the present war, and the obvious fact that the government does rely upon them for guidance as well as for administration, has multiplied the opportunities for such administrative announcements. That the government is alive to the dangers of this tendency is evident from a statement made in Parliament on 11th February by Finance Minister Ilsley, in reply to a member's criticism of a speech made by Mr. Gordon, chairman of the wartime prices and trade board. As this seems to be the clearest exposition of the government's viewpoint that has been issued thus far, it is quoted at some length herewith:

"With regard to the question of speeches by administrative officials generally, may I point out that it is necessary for them to make some speeches . . . . But matters of government policy are announced by ministers themselves . . . . I could not make my point any clearer, however, than by making reference to two speeches made in the month of December last. At the beginning of that month the government embarked upon a new policy of stabilization of the cost of living index by subsidizing consumers in the purchase of certain commodities. It would have been improper for Mr. Gordon to make an announcement of that policy, because it was a distinct departure from earlier policy and could be made appropriately to the public only by a minister. On the other hand, when a little later in the month it became necessary to ration butter, it would have been, I suggest, equally improper or at least less appropriate for the minister to announce such rationing, because the wartime prices and trade board had already been vested expressly by order in council with the responsibility of deciding when it became necessary to ration certain commodities. They were given the power of rationing commodities, of seeing that there was fair distribution. That was the position with respect to sugar, tea and coffee, and it was true also of butter. This does not mean that the wartime prices and trade board does not keep in touch with the government. I keep closely in touch with what they do, and I take

responsibility for their actions. Announcements of new policy, or departures from policy, are for the minister, but announcements having to do with the carrying out of policies already decided upon by the minister and the government are for the heads of the various boards concerned."

While this is a satisfactory explanation of the theory, the thoughtful citizen, recalling certain speeches that have been made in the past, is entitled to question whether it has been observed in practice. No doubt the government has its worries over the fact that scores of the men who have been drawn from industry for temporary war jobs are not steeped in this particular tradition of the civil service, and are not bothering to absorb it, so that in the course of announcements or speeches they do let drop hints of future changes in policy. For instance, a number of them have ventured to suggest that a lot of these boards and regulations will remain after the war—which is clearly speaking on behalf of whatever government may be in power at a time when conditions will be entirely changed. Naturally it is hard for any one who is inexperienced in a public post to draw a sharp line between his official duty and his personal impressions. But in view of the growing fear of totalitarian government digging itself in, it is a good thing for both the government and the people to keep on the alert by continually re-asserting such basic distinctions between responsible government and bureaucracy.

Farmers and Excess Profits Tax

Since relatively few farmers paid income tax, at least up to the present, it seems a far cry to associate them with the excess profits tax, yet there is adequate authority for so doing. Senator W. M. Aseltine, of Rosetown, Saskatchewan, asserted on 5th February that "with good crops and better prices today many farmers find themselves in the excess profits bracket." He explained that, after some years of depression, the war had brought a combination of improved crops and prices, and he referred especially to the flax crop in his territory last year. He continued: "Many farmers are now liable for the excess profits tax, but they are unable to pay this and the high income taxes and also reduce their debts and replenish their worn out equipment. These men are in a

deplorable financial position, almost without any hope at all for the future. As a result, many of them are paying on their debts in order to save themselves from bankruptcy—that is, they are complying with the proposals made by the Board of Review under the Farmers' Creditors Arrangement Act—and are not paying any income tax at all."

To the practising accountant and the financial executive, whose lives these days are a constant wrestle with the impact of taxation, it may be some small consolation to learn that the farmer is aware of the excess profits tax as a personal impost, even though at the same time he appears to have discovered a loop-hole in it.

Education and the Draft

A pamphlet comes to hand printing some correspondence of The Canadian Social Science Research Council with the Prime Minister of Canada. Late in December the Council sent him a memorandum commending the government's policy regarding continuation of academic work in Canadian universities along with military training of all fit students, and elaborating upon the advantages which result, including the production of highly skilled personnel for the armed services or for the complex work of governments. Honourable Mr. King, in replying on 6th January 1943, stated: "In the provision already made by the government for assistance to men demobilized from the armed forces to continue their education, the importance of a liberal education is fully recognized. I am making a copy of your memorandum available to the Minister of Labour in order that the officers charged with the administration of the National Selective Service regulations may have the benefit of its representations."

The chartered accountants' profession has been heavily drawn upon for both the armed forces and the public service, leaving it in a serious plight in respect to personnel. Through training and examinations a small number continue to qualify, but the difficulties in meeting the arduous work of today are such as to call for the utmost consideration of the government.

SOME OBSERVATIONS ON THE REVIEW OF INTERNAL CHECK AND CONTROL

By H. C. Dell, Chartered Accountant, Toronto

THE increase in the volume of work together with the other problems created by the war has forced the harassed chartered accountant to review all work performed by him to see if any of it can be reduced or eliminated entirely without decreasing the effectiveness of his audit. In determining what reduction in work is possible and practical his main source of information has been his written notes on the system of internal check and control in operation in his clients' offices. From these notes he has been able to determine the audit work that must still be performed, the work that may be reduced and the work that may be eliminated entirely.

Internal check and control refers to those internal procedures of a business which have to do with the accounting operations or which are closely related thereto because of their financial aspects. Internal check has been defined as "the co-ordination of the system of accounts and related office procedure in such a manner that the work of one employee independently performing his own prescribed duties checks continuously the work of another as to certain elements involving the possibility of fraud or error." Internal check implies that some fact has been verified by two independent methods or persons so that the responsibility for the accuracy of that fact has been assured from two independent sources. To obtain this objective requires that responsibilities, activities and proofs be so arranged that cross checks operate on all important phases of the transactions in such a manner that all significant deficiencies are brought to the attention of responsible officials in order that they may be dealt with properly.

Present Day Importance

Years ago when detailed auditing was the rule and not the exception as it is today, the auditor was automatically brought into contact with a client's system of internal check and control and accounting procedures and he was thus given an opportunity of studying these procedures at the same time that he was conducting his detailed audit and examining the financial statements. Under these con-

ditions no separate review of internal check was required. With the passing of time the practice of the independent auditor has gradually changed from a programme of detailed auditing to one of test checking. Not only would it be impossible from the practical point of view to make a detailed audit of all transactions of some of the larger corporations today, but it would be a waste of money and effort as internal control has improved so materially with the growth of these corporations that in the majority of cases very little benefit would result from a detailed audit.

This change in the practice of the independent auditor has now reached the point where it may be said that his review of internal check and control in clients' offices is one of the most important phases of his work. His review has taken on additional importance in the last year or two as a result of the war, which has made it essential to eliminate all unnecessary work and to carry on with a smaller and less experienced staff. A proper review should indicate where detailed audit work can be reduced or where a client's system of control can be altered to make less detailed checking by the auditor necessary.

The importance of a systematic review of the internal check has in recent years been impressed upon the profession by the Securities and Exchange Commission in the United States which requires that the accountant's certificate "shall contain a reasonably comprehensive statement as to the scope of audit made . . . ." The Commission in its regulation S-X, rule 2-02 goes on to state that "In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

Reasons for Making a Review

Examples of collusion are found occasionally, but an analysis of a large number of cases of fraud shows that in not more than 10% of them was collusion a factor. The general principle of all methods of internal check and con-

trol is that no one person in an organization shall be in complete control of any important part of the operations. If the independent auditor satisfies himself that the system of internal check and control is effective, not only in theory but in practice, he may feel confident that the chances of fraud being perpetrated have been substantially reduced.

The most important reason, however, for reviewing the system of internal control is that it provides one of the important bases for the independent auditor's opinion as to the correctness of the financial information appearing in the company's books and accounts and therefore directly supports the auditor's opinion regarding the financial statements. Such a review provides the auditor with a general knowledge of the accounting procedure and personnel as a basis for defining the scope of his examination and determines whether accepted principles and methods are being consistently followed and whether there are weaknesses in organization methods and internal audit which invite irregularities by either the management or employees.

There is no such thing as a perfect system of internal control. No matter how perfect a system may have been at the time it was designed and installed, it is operated by human beings and often breaks down at certain points as a result of unauthorized variations in checks or by discontinuing procedures still believed to be in effect by the management. In addition, there is the possibility of collusion and some particular internal control may be made ineffective in this way. Any system of internal check that has been designed in a thoughtful manner should balance the risks of loss which exist on one hand against the cost of installing and operating various safeguards on the other. A reasonable balance between these two factors usually will not provide a theoretically perfect system of internal check even if it were assumed that human beings are not subject to error and temptation. The independent auditor will spend more time testing those sections of a client's records where these imperfections occur than those sections where the system of internal control is excellent. The same problem that the client has is also faced by the auditor and his study of the system of internal control and the development of his auditing programme must necessarily have regard to justifiable cost.

Prepare a Written Record of Review

The review of the internal check and control should not be mere looking around or random questioning but should be systematic, deliberate, continuous and comprehensive. There are the following reasons for preparing a written record of the review:

1. It proves that the test checking employed by the auditor in the case of any individual client was scientifically planned to meet the requirements of that particular client's organization and accounting system and was not determined in a haphazard manner.
2. It provides the partner or senior who reviews the working papers with the information necessary to decide whether the examination has been adequate.
3. If litigation should arise out of irregularities that were not discovered during the course of the audit the written record provides the best possible evidence to support the auditor's testimony in court. This is of particular importance when the litigation requires the auditor's testimony many years after the date of the engagement.
4. It provides an excellent memory refresher for the senior in charge at the beginning of each recurring examination. If the senior is new on the engagement it has a very definite educational value.

Who Should Make the Review and When Should it be Made

The most common practice is to have the review made by the senior accountant in charge of the audit as it provides him with the background required to supervise his assistants and it enables him to derive the greatest benefit from the information which he obtains through his contacts with the client's operations. Furthermore, only a senior man has the necessary experience to make a proper review although he may delegate sections of the review to more junior members of the staff working under his direct supervision.

The review of internal control should be made before the balance sheet date in any case and preferably before the audit is started, as there is an obvious relationship between the review and the determination of the test checking which is conducted by the auditor. If no review were

made, there could not be any real basis for deciding the nature and amount of test checking to be performed in order to compensate for weaknesses in the client's system. It must be recognized that certain portions of the review cannot be completed until the audit programme is finished as certain of the proofs that the theoretical check is working in practice are most easily obtained during the course of the audit. Examples of checking which serve both as part of the review of internal control and as regular audit procedures are the examination of approved vouchers and receiving records and the review of properly approved evidence supporting returns and allowances.

The record made of the internal check must be flexible to provide for the changes that take place almost continuously in accounting procedure, business, personnel, organization relationships, etc. Many of these changes occur so gradually that they may not be easily noticed, with the result that the auditor must check the effectiveness of the internal control constantly. This necessitates building a part at least of his record of review from time to time during the course of his engagement.

Method of Approach

There is no uniform procedure among practising accountants as to the method of approach employed in reviewing internal control. Some of the methods used are:

(1) **Questionnaire**—This consists of a series of questions usually classified according to type of asset, designed to bring out any weaknesses that exist in the system of internal control.

(2) **Flow Chart or Table**—In this approach the internal control maintained over the assets as they flow into, through and out of the business is recorded in the form of either a chart or a table.

(3) **Check List**—This is somewhat similar to a questionnaire and consists of a series of procedures that should be followed in reviewing the internal check with appropriate spaces for placing a check mark or initial when each procedure has been completed.

(4) **Reminder List**—A list of this nature usually explains what characterizes good internal control and what general procedures should be followed in making the review.

(5) **Incorporation in Regular Audit Chart**—Under this arrangement the questions or suggestions in respect to the review of internal check are incorporated in those sections of the audit chart to which they apply.

(6) **Organization Chart Approach**—Either the client's organization chart or one prepared by the accountant himself is sometimes used as the basis for reviewing the system of internal check.

(7) **Accounting Record Approach**—A list of the accounting records and recordkeepers of a client together with a list of custodians of valuable assets and their duties and a list of the origin of accounting documents is occasionally employed as the basis for making the review.

(8) **General Bulletin**—This consists of broad instructions and general explanations of the problems involved. It may also indicate the nature of the information required in the notes to be prepared on the review.

Each method of approach has its own particular advantages and disadvantages. It is suggested that the most practical solution is to employ a questionnaire for large businesses only and use the flow table for medium size and smaller businesses and for this reason only the first two approaches mentioned above will be discussed herein.

Irrespective of the particular method of approach used by the accountant, his review must be classified primarily according to assets and should indicate the receipt of the assets by the business, their flow through the business and their final disposition whether it be their conversion into other assets or their flow out of the business. The review will have as its major objective the determination of how effectively the system of internal check and control and accounting procedures accounts for these assets and the extent of the review will be determined largely by the particular characteristics of these assets.

The first step in making the review is to obtain the client's representations as to what the system is. These may be obtained from instruction manuals or from statements made by officers and employees of the client. The next step is to determine as far as practical whether the procedures actually agree with those represented by the client to be in operation. This is very important as it will

often be found that the checks theoretically in operation are not carried out in practice. The final step is the consideration of the effectiveness of the system and the determination of what audit procedure should be followed and what recommendations should be made to the client to improve his internal control.

Where the client whose records are being audited has an internal audit staff, it is usually desirable to make use of the work of such staff. As the internal audit is part of the system of internal check, its efficiency will be tested by the independent auditor as part of his review and if these tests are quite satisfactory in every respect it should be possible for him to rely upon the work done by the internal auditors. For instance, if he does not visit all his client's branches each year he may arrange to have the internal audit staff review the system of internal check and control of these branches and report thereon to him.

The annual written record of the review should be in addition to the brief notes in the permanent file which should be kept up to date covering points of permanent significance such as those dealing with bonding of employees, signatures on cheques, deposit safeguards, rules regarding cashing cheques and making purchases for employees, etc. The permanent file should also contain lists of records, recordkeepers and custodians supplied by the client, together with a notation of the vacation and rotation policies that are followed.

The Questionnaire Approach

The more important objections to a questionnaire are that it is hard to prepare questions which will obtain really informative replies and that it is too lengthy for small jobs where the amount of time required to answer the questionnaire would be out of line with the time spent on other phases of the engagement. Another important objection is that it may tend to act as a damper on the auditor's imagination and resourcefulness. For these reasons it is suggested that a questionnaire should be used only on relatively large engagements and should be so designed that it will bring out all of the answers that are ordinarily required. When this is done it acts continually as a review of principles of internal control for the senior men, which stands them in good stead in using the flow chart approach

described below. Such a questionnaire may be filled out each year, or in the case of large engagements where the same senior remains in charge in successive years, sufficient columns may be included to take care of two or three years on the same questionnaire. After two or three years, however, a new questionnaire should be filled out without making any reference to its predecessor until the new questionnaire has been completed.

The Flow Chart Approach

In the case of medium size and smaller businesses, it is suggested that it is most practical for the senior man to approach the review from the point of view of the flow of the assets into, through and out of the business. If you were an engineer, or if graphs appeal to you, your idea of a flow chart (and a very good one it is) might be to record the operations performed in their proper order on the left side of a sheet of columnar paper and to head each separate column with the name of a recordkeeper or custodian. An examination of such a chart would indicate the work performed by each person within the organization, the checks and controls in operation and would also indicate the danger points that require special attention. The auditor's conception of a flow chart or table, however, is more likely to be one where the flow is indicated in one column, the operation performed and the recordkeepers and custodians shown in a second column and the method of control recorded in a third column.

In practice when a senior starts to review the internal check and control in each client's office his first problem is to determine what are the valuable portable or negotiable assets of the client. These will usually be cash, securities, receivables and inventories and the problem presented by these assets will vary with the type of business. For example, the inventory of a pig iron manufacturer does not present the same problem of misappropriation as does the inventory of a diamond merchant.

Having determined what are the valuable portable or negotiable assets of a client, a brief flow chart or table should be prepared. For instance, in the case of inventory it might show the request for materials being sent to the purchasing department, the purchase order being given, the goods being received, the goods going into stores, the flow

of material through the business into finished stock, the order being received for sales, the goods being shipped and invoiced and their conversion into another asset such as accounts receivable or cash. Such a flow table would indicate the several points at which trouble might occur and with this in mind the senior in charge should review with the proper officials and employees the internal check which purports to be in operation in the client's office and make rough notes thereon on the flow table. The next step should be to ascertain if the theoretical system outlined by the officials and employees does in fact work in practice. This will be done by finding out from the employees who do the work, whether their practice is what their executives think it is. This information will be further verified by incorporating into the audit chart a series of questions on each section of the work to ascertain that the controls and checks actually work in practice.

The flow table if properly prepared may be the final product, but is ordinarily only a means to an end and having determined what is the actual procedure, a concise set of notes should be prepared on the system of internal check and control, classified primarily according to assets, or in certain cases by types of revenue and expenditure. These notes should record the flow of the assets into, through and out of the business and indicate clearly how such assets are accounted for by the system of accounting, internal control and internal audit and in what respects the system is deficient.

The attached exhibits "A" and "B" indicate how the notes on the review of internal check and control of the cash receipts of a theoretical client might have been recorded under each of the two methods of approach discussed herein. The flow table approach may be most clearly demonstrated, perhaps, when applied to inventories and for this reason, a section of a flow chart dealing with this asset is also attached as Exhibit "C."

Recommendations to Client

After the review has been made, it is possible for the senior to eliminate from the audit chart any unnecessary work which may have been done previously, and where necessary to increase the work to cover weak points in the client's system that cannot be taken care of by changes in

the client's routine. After the notes on the review have been read by a partner he should discuss with the client any recommendations necessary to increase the effectiveness of the internal control and should subsequently put these recommendations in writing in a letter to the client. Such letters should be followed up at a later date to see that the recommendations are carried out. Where the internal control is not as satisfactory as it should be under any particular set of circumstances and where the client refuses to do anything to make it more effective, the auditor should report specifically to the client that this is the responsibility of the management and that until it is corrected the effectiveness of the audit is thereby lessened.

It should be unnecessary to add that any deficiencies in bookkeeping noticed when making the survey of internal control should be noted and any suggestions which would reduce the work or increase the efficiency of his staff should be discussed with the client.

Summary

The foregoing thoughts may be briefly summarized as follows:

1. With the transition from detailed auditing to test checking the review of internal check and control has assumed a role of major importance in the independent auditor's work. This has been emphasized in the United States by the requirement of the Securities and Exchange Commission that auditors must review the system of internal control of companies registered with the Commission. This review has assumed even greater importance recently as the result of the war which has made it essential for the independent auditor to eliminate all unnecessary work and to carry on with a smaller and less experienced staff.

2. The review of the system of internal control provides the independent auditor with the knowledge that permits him to express an opinion as to the reliability of the financial statements of his client. It also provides him with the information required to define the scope of his audit and to ascertain weaknesses in organization methods and in-

(continued on page 188)

EXHIBIT A

THE BLANK COMPANY LIMITED
QUESTIONNAIRE ON REVIEW OF THE SYSTEM OF INTERNAL CHECK AND CONTROL

QUESTIONS	"YES" OR "NO"	OTHER ANSWERS OR REMARKS
Cash receipts:		
1. Cash received through the mail:		
(a) Is incoming mail opened by persons not otherwise connected with cash or with the accounting department records?	Yes	
(b) Does the office routine prohibit delivery of any unopened mail to employees who have access to cash?	Yes	Personal letters are the only exception.
(c) Is a record prepared of all receipts before they are passed on to the employees who record them in the books and make the deposit?	No	See note under (d) (ii) below.
(d) (i) If such a record is prepared is it turned over to an employee not otherwise connected with the cash who reconciles this record with the deposits made each day?		
or		
(ii) If such a record is not prepared, are the remittances sent directly to the cashier for deposit and the remittance slips sent directly to the accounts receivable department for recording in a cash receipts record and posting to customers' accounts?	No	Mail is given to office manager who passes receipts on to cashier. Office manager scrutinizes cash book. Accounts receivable ledger is posted from cash book and remittance advices.
(e) Does an employee not connected with either cash or the accounts receivable department check the total of postings to the accounts receivable with the total of deposits daily?	No	(1)

Questions	"Yes" or "No"	Other Answers or Remarks
(f) If none of the checks outlined above are in effect is there any other control to ensure that the daily total is independently checked from two different sources?	No	Cashier has no access to accounts receivable or billing records and accounts receivable and billing clerks have no access to cash.
2. Cash received otherwise than through the mail:		
(a) What methods of control are in operation to ensure that all receipts by cashiers, salesmen, collectors, etc., are properly recorded and turned in daily?		**Cash sales**—Orders prepared in duplicate. Invoices prepared from orders and cross-referenced to them by an employee not otherwise connected with the handling or recording of cash who also accounts for consecutive numbers of both orders and invoices. Total of daily postings is not checked from sales recapitulation to cash book by accounting department (2). **Collections**—Collections are turned in to cashier daily and duplicate receipt books are given to the accountant who checks them to cash receipts book. Accountant controls unissued books and accounts for all books issued. Collectors have no access to statements which are mailed monthly. Territories are switched periodically.
(b) Does an employee not otherwise connected with the handling or recording of cash record sundry cash receipts which may be expected (such as rents, claims, refunds, scrap sales, etc.) and ascertain that these are received?	Yes	Record of all expected sundry revenue items maintained by accountant who has them set up as receivable by journal entries. Scrap sales are satisfactorily controlled through approved shipping orders that are all accounted for and cross-referenced to invoices by a clerk not otherwise connected with the handling or recording of cash.
(c) Does an employee not otherwise connected with cash or securities ascertain that all dividends and interest on securities owned which should be received are properly recorded?	Yes	
3. Are all cash receipts promptly deposited in bank?	Yes	(3)
(a) Does the duplicate deposit slip show clearly the names of customers' cheques, bank transfers, etc.?	No	Deposit slip prepared by cashier and checked by accountant. Deposit taken to bank by office boy and stamped duplicate deposit slip returned directly to accountant who obtains cheques and statements from bank and reconciles bank account. Returned items, etc., are scrutinized by him.
(b) Is this slip checked by an employee not otherwise connected with cash and turned over to the employee who reconciles the bank accounts?	Yes	

Questions	"Yes" or "No"	Other Answers or Remarks
(c) Is the deposit then sent directly to the bank without returning it to the employee who prepared the deposit?	Yes	
(d) Is the cashing of accommodation cheques out of currency receipts and including these cheques in deposits in lieu of such currency prohibited?	Yes	Cheques are cashed only from petty cash fund.
Notes (1), (2) and (3): Recommendations to correct these weaknesses in internal check were reported to the Board of Directors in our letter of 15th October 1942.		

SOME OBSERVATIONS ON THE REVIEW

(continued from page 185)

ternal audit which invite fraud either by employees or by management.

3. A written record of the review should be made to provide evidence that the review was systematic, deliberate and comprehensive and that the plan of test checking used was specifically designed to meet the particular requirements of the individual client's organization and accounting procedures.

4. The review should be made by a senior man before the audit is started although some portions of the review usually cannot be completed until the audit programme has been finished as certain of the proofs that the controls are operating satisfactorily are most easily obtained during the course of the audit.

5. There are many methods of approach that may be employed in making the review but it has been suggested in this article that a carefully prepared questionnaire be used for large businesses, and a flow chart approach be employed for medium size and smaller businesses.

EXHIBIT B

THE BLANK COMPANY LIMITED

NOTES ON REVIEW OF THE SYSTEM OF INTERNAL CHECK AND CONTROL

CASH

Flow	Operation performed	How controlled
Cash received from following sources:		
(a) Mail	Mail opened by switchboard operator with exception of personal letters.	Operator has no other connection with cash or accounting records.
	Mail given to office manager. Receipts passed to cashier for recording in cash book.	Office manager scrutinizes cash book periodically. Cashier has no access to receivable or billing records.
	Credits posted by clerk to accounts receivable from cash book and remittance advices.	Clerk has no access to cash. Total of daily postings is not checked to cash book by accounting department (1).
(b) Sale of scrap	Serially numbered shipping order originates with order clerk—approved by plant manager. Later returned to office with details of shipment.	Order clerk has no access to cash. Order numbers accounted for and cross-referenced to invoices by accounting department.
	Invoice prepared in usual manner.	Gateman and shipper will not let any shipment out of plant without properly approved shipping order.
	Cashier receives remittance in usual manner.	
(c) Cash sales	Serially numbered orders prepared in duplicate by order department.	Consecutive numbers on orders accounted for by office clerk who also cross-references orders with invoices.
	Copy 1 to stock clerk.	Authority to stock clerk to release goods.
	Copy 2 to file from which invoice is typed while goods are parcelled.	
	Three copies of invoice prepared: Copy 1 to customer. Copy 2 to cashier and then to receivable clerk for posting receivable ledger.	Invoice clerk has no access to cash or receivable records.
	Copy 3 to file.	Numbers accounted for and sales recapitulation prepared.
	Customer pays cashier who records total receipts each day.	Total of daily postings is not checked from sales recapitulation to cash book by accounting department (2).

EXHIBIT B (Continued)

THE BLANK COMPANY LIMITED

NOTES ON REVIEW OF THE SYSTEM OF INTERNAL CHECK AND CONTROL

CASH

Flow	Operation performed	How controlled
(d) Collections	Collections remitted to cashier daily.	Collectors have no access to statements which are mailed monthly.
	Duplicate receipt books turned in to accounting department.	Duplicate receipt books are checked to cash receipts book by accounting department which also controls all unissued books and accounts for all books issued.
		Territories are switched periodically.
(e) Sundry (Rents, claims, dividends, etc.)	Set up as receivable by journal entries by accounting department.	Accounting department which handles no cash maintains records of sundry revenue that should be received.
Cash deposited in bank	Daily deposit slips of all receipts prepared in duplicate by cashier.	Deposit slips checked by accounting department and given directly to office boy to make deposit.
		Names on cheques not shown on deposit slips (3).
	Deposits taken to bank by office boy.	Duplicate deposit slips stamped by bank and returned directly to accounting department.
	Accounting department reconciles bank.	Accounting department obtains cheques and statements directly from bank and scrutinizes returned items, etc.
	Cheques are cashed only from petty cash fund.	Cashing of accommodation cheques out of currency receipts is prohibited.

Notes (1), (2) and (3):
Recommendations to correct these weaknesses in internal check were reported to the Board of Directors in our letter of 15th October 1942.

EXHIBIT C

THE BLANK COMPANY LIMITED

NOTES ON REVIEW OF THE SYSTEM OF INTERNAL CHECK AND CONTROL

INVENTORY

Flow	Operation performed	How controlled
Purchase requisition	Requisition for material signed by storeskeeper sent to purchasing department.	Purchase order requisition in duplicate is attached to minimum quantity on shelf or bin and when the minimum is reached, purchase order is automatically released to purchasing department.
		Storeskeeper retains one copy which is destroyed when he receives a copy of purchase order.
Purchase order	Typed in quintuplicate:	Serially numbered—signed by purchasing agent.
	No. 1 copy to vendor	
	No. 2 copy retained by purchasing department	Acts as check on unfilled orders—scrutinized twice a week by purchasing agent.
	No. 3 copy to storeskeeper	Acts as acknowledgment that order has been issued. Kept as a check on material ordered but not received.
	No. 4 (pink) copy) No. 5 (yellow) copy) to receiving clerk	See below—these copies do not indicate quantities or prices.
Material received by receiving department	Quantities filled in on No. 4 and No. 5 copies of purchase order which then act as receiving slips. No. 4 copy is initialled by receiver and passed along with the material to the various storeskeepers.	The receiving clerk files yellow (No. 5) copy numerically in case the pink receiving slip (No. 4) should be mislaid—destroyed at end of six months.
	Blue receiving slips are made out in triplicate by the receiving clerk for returned sales—one copy is sent to the credit department and the second copy goes to storeskeeper with the goods.	Receiver files third copy numerically. Receiver refuses to accept any items, except returned sales, for which he does not have a proper purchase order.
Material put into stores	Receiving slip checked by storeskeeper who adds any additional information necessary for checking invoice, initials slip and sends it to accounting department.	No. 3 copy of order is noted as filled and filed numerically in case receiving slip should be mislaid—destroyed at end of six months.

EXHIBIT C (Continued)

THE BLANK COMPANY LIMITED

NOTES ON REVIEW OF THE SYSTEM OF INTERNAL CHECK AND CONTROL

INVENTORY

Flow	Operation performed	How controlled
Material put into production	Requisition approved by foreman required for all materials taken from stores.	Requisitions are serially numbered by a numbering machine as received and sent to accounting department daily for posting to book inventory records. Notes on stores control: A detailed stores ledger is kept in the accounting department showing both quantities and dollar values. The ledger cards are posted from the following information: Receipts—from invoices at which time the invoice is initialled by ledgerkeeper. To ensure that all invoices pass through his hands he detaches the copy of the order from the invoice and files it numerically. Periodically he accounts for all numbers. Disbursements—from requisitions received from the stores department. These requisitions are serially numbered and all numbers are accounted for. A physical inventory of some of the items in stores is taken by the storeskeepers each day as convenient and sent to the stores ledgerkeeper who brings his cards into agreement with the count, if necessary. Any discrepancy in excess of $10 is reported to the production manager. A distinctive flag is put on each card as counted to ensure that all items are counted twice each year. To make certain that the storeskeepers actually take physical inventories no shelf or bin inventory records are maintained.

BALANCE SHEET PROCEDURE AND AUDIT WORKING PAPERS*

By E. H. Ambrose, Chartered Accountant,
Toronto

MY subject is "Balance Sheet Procedure"—that is, the procedure which should be adopted in the verification of financial statements. It takes most people five or six years or even more to obtain a reasonably sound knowledge of this procedure so we do not expect you to gain a complete education in a few hours. However, if you can grasp the fundamentals and understand why various parts of the work are done you should find your practical work more interesting. I am going to divide this lecture into four parts:

1. Why financial statements are required and their use.
2. The purpose and form of working papers.
3. Verification of balance sheet items.
4. Verification of the profit and loss account.

Why Financial Statements are Required and Their Use

Most of you know a certain amount about financial statements—why they are required, their content and use—so I will dwell only briefly on this point. Broadly speaking, financial statements consist of a balance sheet, surplus account and a statement of profit and loss.

Balance sheet—this is a statement of assets (cash, accounts receivable, inventories, plant, machinery and other things owned by the company or individual) and liabilities (accounts and bills payable, bonds payable and other items owed by the company or individual, plus the net worth of the business represented by capital and surplus)—it shows the position of a business at a given date.

Profit and loss account—this shows the results of operations of a business for a given period.

Surplus account—the balance of this account represents the accumulated profits undistributed to the shareholders.

These three statements are all related. The net worth of the business—that is the shareholder's interest—is represented by the capital invested in the business by the shareholders, plus the undistributed profits (surplus ac-

*This is the fourth of a series of six articles relating to the subject of Staff Training.

count). This net worth is the excess of the total assets over the liabilities to other than shareholders. The surplus account on a financial statement shows the movement in this account during the year, that is the balance of profits undistributed at the beginning of the period to which is added the net profit (or loss) as shown by the profit and loss account, from which is deducted any dividends paid to shareholders during the period. Thus the profit (or loss) for the period is carried forward to the surplus account and the accumulated balance in the surplus account is shown as such on the balance sheet.

Financial statements have many uses, which may be conveniently summarized under five headings:

1. Shareholders
2. Directors and management
3. Bankers
4. Creditors, including taxation authorities
5. Financial houses

We are employed upon occasion to report upon financial statements of a concern by any one of these groups but our most frequent employers are the shareholders since all limited companies by statute must have an audit made of their books each year and must have their financial statements certified by auditors. The uses of financial statements by the various groups are somewhat different in nature but from the auditor's point of view they have one thing in common—he must give an unqualified report only when he is satisfied that the statement presents a true state of affairs; it is his responsibility to give an independent opinion and if he does not agree with the statement presented to him for examination he must in all cases state where in his judgment any difference occurs.

The main uses of financial statements by each of these groups are as follows:

(1) **Shareholders**—The shareholder is primarily interested in how much money the company has made and how much of it belongs to him. He is usually our employer and we report to him on the correctness of the balance sheet and operating statements that are presented to him by the directors of a company.

(2) **Directors and management**—Financial statements show operating results for periods which are completed, the financial position at the present and may be used to inter-

pret trends in the future. In the case of many smaller businesses the managers either own or control the company and, therefore, a report to the shareholders is also a report to the management. In many cases the management has no idea how much money the company has made until we go in and prepare a statement, but fortunately these cases are in the minority. In the case of smaller companies the statements which we present are usually far more detailed than in the case of larger clients; in such cases we are consultants and accountants as well as auditors and we can be very helpful in explaining to these small clients why their profits have increased or decreased, together with other aspects of their business. In the case of larger clients, trained accountants and analysts are usually available on their staffs, although we are frequently called in for consultations and interpretation of their results.

(3) **Bankers**—A banker is interested in the financial statements of any company which is indebted to his bank. In such cases the statement will be subjected to close scrutiny to see that the loan is adequately secured. Upon occasion bankers ask us to prepare special financial statements on customers whose loans they deem unsatisfactory. This, however, is a specialized side of our work and I will not dwell on it further.

(4) **Creditors**—Creditors are primarily concerned with the ability of their debtors to pay their liabilities in full, and therefore the working capital position—the excess of current assets over current liabilities—is of the greatest interest to them. In these days of high taxes the most important creditor of any company is usually the Dominion government. We have a very great responsibility to the government and must use all possible diligence to ensure that profits are correctly stated. I might stress here the difference between "avoiding" and "evading" taxes. Certainly we will help a client to avoid paying any more taxes than he is required to pay by law; "evasion", however, means breaking the law and we must at all cost prevent him from doing this.

(5) **Financial houses**—During the period when stock floatations were made in large numbers and new bond issues were being floated by corporations we were frequently asked by the financial houses interested in a floatation to certify the balance sheet and statement of earnings submitted in

the prospectus. These statements would be used by investors throughout the country to judge the probable worth of the investment. However, those days are gone for the time being and, in any case, represent a rather specialized side of our work.

Purpose and Form of Working Papers

There is a good deal of truth in the remark "Show me an accountant's working papers and I will tell you what kind of an accountant he is." You all know what working papers are—the office is filled with them from cellar to attic—but you may not fully understand their purpose and importance. Actually a thorough understanding of accounting principles and auditing procedure is necessary for a full comprehension of the function of working papers but it is important that you grasp their fundamental purposes and the necessity of preparing them in a complete and logical manner.

The purposes of working papers may be summarized under five heads.

(1) **Review of working papers**—In common with other large offices our procedure in regard to the preparation of working papers and financial statements is as follows:

(a) The detailed working papers covering all aspects of the job are prepared under the supervision of the senior in charge of the engagement, who then uses them to prepare the financial statements and reports.

(b) The work is then reviewed by two of the staff seniors or partners. The purpose of this review was stated most clearly by one of the witnesses in the McKesson and Robbins case—where there was a large shortage in inventories and receivables. This is as follows: "Generally the purpose of the review is to make sure that the prescribed examination steps have been taken and that they are adequate; that the financial and operating statements prepared are properly supported in the working papers; that the suggested comments are in order and proper; and that no essential comments have been omitted; and to make such modifications as a study of the working papers and the conference with the supervising senior and sometimes with some of his assistants who are on the engagement indicate to be in order." The importance of checking the detailed work done as well as the financial and operating statements

and reports issued by the auditor is self-evident. The programme of check and review described above cannot possibly be carried out without proper and adequate working papers.

(2) **Working papers as models**—Many of man's (and for that matter woman's) activities are carried on by the process of imitation. While we try to encourage individual initiative as much as possible, there are many phases of auditing work which are of a recurrent nature, especially in the case of continuous audits of the books and records of the same client over a number of years. Therefore the working papers prepared for one year may serve as a model and guide for subsequent audits and this has become increasingly important in our office the last few years because of the large turnover of staff which has necessitated the assignment of new men to the various jobs. I certainly do not mean to imply that all working papers prepared in our office are models, because some of them are not; generally speaking, however, they serve a very useful purpose in guiding new men through a job for the first time and reference to the previous year's papers frequently keeps the tempers of the client's staff on a more even keel. For instance it is most annoying to a client to ask him full details about a particular aspect of the work which has been explained in detail to a member of our staff in the previous year and the procedure for which has been fully noted in the working papers. However, do not copy last year's working papers in an unimaginative manner; they can usually be improved and if you do improve them you will get credit for it; therefore, use them as a guide but do not think that they are perfect and follow them blindly.

(3) **Investigation and inquiries**—I stated previously that working papers are the basis for financial statements, etc. That is only the first step. Some years from now there may be inquiries from any one of many sources such as tax departments, government commissions or other agencies requiring explanations or supplementary information regarding the statements previously submitted. If this occurs, in most cases the client asks us to prepare the information. In order to do this we must refer to the working papers and if these were not complete our task would be far more difficult and might prove highly embarrassing.

(4) **Court testimony**—In recent years the professional accountant has become an increasingly important factor in many types of litigation. His testimony is vital in such cases as actions for the prosecution and recovery of embezzled funds, tax controversies, actions charging the issuance of false or misleading financial statements, shareholders' actions against officers and directors of a corporation, etc. Whatever the cause of action may be, working papers are an indispensable aid to the accountant on the witness stand in giving testimony and frequently the accountant's working papers are admissible as evidence (after the books of account have been introduced) to save time and cluttering up the records with prolonged testimony regarding numerous detailed entries in the books.

(5) **Defence of professional integrity**—It cannot be stressed too strongly that the menace of a suit for negligence may have the gravest consequences to a chartered accountant, for his professional reputation and career are at stake. Such suits may be instituted by the accountant's client who claims to have sustained losses as a result of relying upon the accountant's statements which he alleges were negligently prepared and misleading. True these suits are rare but their potential threat cannot be dismissed lightly. It is therefore the responsibility of all of us to see that the work which we do is sufficiently exhaustive so that we will not be held responsible if an action should occur.

Working papers are the connecting link between the client's records and the auditor's report and form generally the sole evidence of the correctness of the report or certificate. Even without the threat of a lawsuit a memorandum or note in the working papers may relieve many an embarrassing situation. All human beings probably relegate to the back of their minds unfavourable or unpleasant experiences and accountant's clients are no exception to this rule. They may frequently resist our recommendations of changes in office procedure and internal control to tighten up some weak spot in their organization where we feel fraud might occur; their usual grounds for rejecting our recommendations are that they would entail additional expense or work. However, when a defalcation occurs they look to the auditor with a sense of reproach because he did not prevent the misappropriation of funds. If the auditor can refer to

his working papers containing a memorandum of suggested recommendations brought to the client's attention and disregarded by him, or to a letter he has written the client making such suggestions, he should have no difficulty in absolving himself from any responsibility for the unfortunate situation.

It is, therefore, of the utmost importance that these papers should show fully the composition of significant items and the methods of verification adopted for each, together with notes on any controversial points raised during the audit, and in many cases notes of conversations with officials of the client. These records constitute the auditor's main defence in the event of criticism of his work or findings.

I have now told you the main purposes of working papers but I should like to say something about their form and the method which should be used in preparing them. You have all received a memorandum on this subject which was prepared a few years ago in the office and which should be read thoroughly by all of you. There may be some things in this memorandum which you do not understand but your staff seniors will be glad to answer any queries you may have in this regard.

Mr. Montgomery, one of the foremost authorities on auditing, has said "The more inexperienced an auditor is, the more working papers he produces." On the other side of the picture is the auditor who prides himself on the paucity of his working papers. What we must reach is a happy medium between these two extremes. Working papers should be *clear, concise and complete.* By clear, I mean not only legible but with the facts set out in a straightforward, logical manner. This is an art which is gained through experience but some people never seem to gain it because they do not plan their work properly. When you are assigned to a job make sure that you understand the purpose which the work serves and the conclusions which you are expected to reach. Much time has been wasted in the past in the unnecessary rewriting of schedules due to the lack of forethought given to planning the form of the working papers. Do not use two or three schedules where one will do but at the same time it is false economy and most confusing to find listed on a single sheet unrelated

details which are difficult to index properly and locate readily.

It is probably superfluous to add that you should never leave trial balances or other working papers which have been partially checked lying about as they might be altered by the staff of the client you are auditing and thus prevent you from detecting a fraud.

I am not going into the form and content of working papers in detail because most of the information is contained in the office folder which you have been given, but there is one further point that I would like to add. Do not accumulate a series of notes when you are working on a job; the only way to plan the work is to clear up each section as it is completed. One final word of warning—Never leave a long list of notes headed "Items to be cleared next audit". There is usually nothing more annoying or futile than to try and clear up notes which are several months old.

Verification of Balance Sheet Items

Before discussing the verification of the various items in the balance sheet I want to explain briefly how the current audit of the detailed transactions which is carried on throughout the year, and which occupies a substantial portion of your time, ties in with the final statements.

As explained to you in the previous lectures on the audit of the various records, we now make a detailed audit of all transactions in only a very few cases. In all cases the extent of our detailed examination of the records is dependent on the system of internal control within the client's office and the importance of this cannot be stressed too strongly. It is necessary to ascertain what portion or portions of the work are handled solely by one person and if this person made a mistake, wilful or otherwise, what would be the chance of such a mistake being detected by someone else in the organization. Our audit of the detailed transactions must be sufficiently comprehensive to satisfy us that the internal check actually operates and to enable us to say that the statement upon which we report, which is prepared from the client's records, presents a true state of affairs.

Before dealing with the individual balance sheet items I would like to try to give you a broad picture of the meaning of the word "verification". Any business (other than

a bankrupt one) at any given date owns certain assets and owes certain liabilities; the difference represents the owner's interest in the business. Our object is to satisfy ourselves that the assets and liabilities actually exist and that the valuation at which they are stated in the company's books is a proper one in each case.

We must also take all precautions necessary to ensure that all assets and liabilities of the company are included in the books. It can truthfully be said that we are more interested in any liabilities which are not shown on the books than those that are and if a client deliberately wishes to understate liabilities it is frequently most difficult to detect these wilful omissions.

My comments later on dealing with such items as inventories and fixed assets will show you that it is frequently not practical to satisfy ourselves completely as to the actual existence but we must take all reasonable precautions available to us. The bases of valuation for the various types of assets differ a great deal and I shall go into this when commenting on the individual items.

You all have with you the office folder on auditing procedure distributed to each member of the staff which indicates the detailed procedure which should be adopted in the verification of individual balance sheet and profit and loss items. The various types of assets and liabilities vary somewhat between companies of different types and sizes so it is not possible to set out a standard procedure which may be followed in all cases. My talk will deal with the assets and liabilities ordinarily found in the records of a medium sized manufacturing concern. There is detailed in the folder the procedure which should be adopted in the verification of these items but it does not tell you why these various steps are taken. I propose therefore to explain to you the reasons why we should carry out the programme set out in this folder.

Assets

Time does not permit me to deal with each individual asset mentioned in the folder and I propose to talk to you only about the more important assets such as cash, receivables, inventories, securities, fixed assets and prepaid expenses. Such assets are owned by most of our clients and if you should be working on the audit of a company which

has mortgages receivable, life insurance, patents, trademarks or other assets not dealt with herein, your senior will explain to you the procedure adopted in the verification of such items and the reasons therefor.

Cash—A previous lecture was devoted exclusively to the audit of the cash records and therefore I will deal with it very briefly. In the case of currency in a client's office we endeavour in all cases to count it at the balance sheet date. In the audit of the records of out-of-town clients this is not always possible but in such cases we count the cash at a subsequent date and trace the entries back from that date to the date of the statement in order to satisfy ourselves as to the correctness of the books at that time. For cash on deposit with bankers we accept a certificate from the bank stating the amount of the balances which our client had on deposit at the balance sheet date. The bank balance must be reconciled with the book balance for any outstanding cheques, deposits, etc., but in practically all cases we are able to examine these cheques and prove the deposits and therefore satisfy ourselves as to the correctness of the books.

Receivables—The existence of accounts receivable—that is amounts due to the company—is verified by sending statements to the customers asking them to report any differences directly to us. It is usual to send out positive confirmations on the larger balances—that is request the customers to confirm directly to us in writing that the balances are correct. This circularization will generally be made during the course of the year rather than at the balance sheet date, the reason for this being—

1. If the bookkeeping staff in a client's office found that it was our practice to confirm accounts only at the balance sheet date the element of surprise would be lost.

2. A great many of our clients end their fiscal years on 31st December and we have not the available staff early in January to do all this work at one time.

The procedure which should be adopted for this circularization is shown in the office folder which you have. It should be noted first of all that this check should be a surprise to the client's bookkeeping staff since if a fraudulent employee had been appropriating receipts from accounts receivable for his own use he might be able to alter

the records in such a way that confirmation of the accounts would not detect his defalcation if he knew in advance that we were going to make the circularization.

We should confirm all accounts including those which have been paid between the confirmation date and the date that we actually mail the statements. If, for example, we are confirming the accounts of a client as at 31st August and are mailing the statements on 10th September, the records of the company may indicate that an account was paid on 4th September but actually the money may have been received prior to 31st August and the funds used in the meantime to cover up a shortage; for this reason all accounts since paid should be confirmed. In some cases clients will insist that payments made subsequent to the confirmation date but prior to the date of mailing be recorded on the statements. We cannot object to this but it is preferable that no indication of payment be made; if, however, the payment is recorded we should make sure that the date of such payment according to the cash receipts book is recorded on the statement.

The cash should always be counted at the close of business on the date at which we confirm the receivables. As previously explained to you, we must verify the amount of cash which *should* be on hand. Payment on accounts receivable is usually the principal source of cash and it is only by confirmation that we can tell whether a customer has paid his account or not. Therefore it is not possible to tie up the cash *completely* unless we confirm the accounts receivable at the date of the cash count. Since it is unusual for us to confirm the receivables more than once a year we should always take the opportunity of making a complete cash tie-up at the confirmation date.

We must always check the trial balance of the customers' accounts against the individual ledger sheets at the balance sheet date and agree the total of such trial balance with the general ledger control account. In cases where the accounts are confirmed at the balance sheet date this trial balance will be taken off at the time the accounts are confirmed.

There is a further check which should be made in order to verify the existence of accounts receivable. We test check during our current audit the shipping records against

the sales invoices to see that all shipments have been billed. This should also be done for the last few days of a company's fiscal year to make sure that it has not shipped goods prior to the year-end, excluded them from inventory and not billed them until the succeeding year. Conversely, we must also make sure that the company does not bill goods prior to the year-end which have not been shipped. If goods were shipped but not billed prior to the end of a company's fiscal year it would result in an understatement of profits and, conversely, if goods were billed and not shipped it would result in an overstatement. Therefore each sales invoice and shipping report for these last few days should be matched and we must see that a sales invoice and related shipping report do not fall into two different fiscal years. I have stated that this check is usually followed for the last few days of a company's fiscal year; in most cases this would probably not detect wilful omissions since it is unlikely that a company trying to pad its sales account would do so during the last few days. This procedure will, however, bring to light clerical errors. We can sometimes detect intentional mistakes by comparing the total sales for the last few months and for the first month of the next year with those of preceding months or comparable periods of previous years; if the variations are material we should obtain satisfactory explanations.

The existence of receivables has now been dealt with and we will pass on to the basis of valuation. The basis of valuing cash is self-evident, since we do not provide for the contingency that the banks will fail, but we must usually provide for the possibility that all acounts will not be paid in full. Therefore we examine the individual accounts as shown by the accounts receivable ledger and form an independent opinion as to whether we consider that the reserve which the company has set up on its books for bad debts is adequate. In aging accounts receivable we must first find out the terms of sale which the client grants to his customers. The usual terms are thirty days and in such cases if we are auditing a client's records at 31st December, all November or prior billings unpaid would be considered overdue. In the majority of cases we get the client to prepare a list of the accounts receivable with an analysis of the amounts overdue on each account. When we check this analysis we should reconcile the unpaid items

with individual billings in the ledger. For example, a customer may be paying his account regularly but may be disputing and leaving unpaid an item some months old. If, therefore, we find that the total amount of his indebtedness is not greater than his purchases during the preceding four weeks and that he has been making regular payments it does not necessarily mean that the account is good; it is possible that he has paid for two weeks of such purchases and that the balance relates to an old and disputed item. For this reason it is important that on all the larger accounts and a substantial portion of the smaller ones we actually relate the balance owing to individual items.

The reserve for bad debts account should be analyzed for the year. It is extremely important that all accounts written off be approved by a responsible official in the organization. If bad debts written off are not properly approved it is easy for a dishonest bookkeeper to obtain funds by placing cash receipts in his pocket and writing off the accounts to which these receipts relate.

Inventories—Since 1939 auditors in the United States have extended the scope of their examination to include the verification of the *quantities* of inventories on hand either by test checking the quantities themselves or by accompanying and observing the client's employees while they are taking the inventory count. Chartered accountants in Canada considered in 1940 whether this United States practice should be followed but decided to defer action until after the end of the war. However, because this is standard auditing procedure in the United States we must follow this practice in the case of our clients who file registration statements with the Securities and Exchange Commission in that country. Except in such cases we do not undertake any responsibility for the taking of inventory unless we are specifically requested by a client to extend our work to cover this. But, while we accept certificates from the management as to the existence of inventory quantities, we also make enquiries as to the procedure which is followed in taking the inventory and make test comparisons of book inventories where available with the inventory count and frequently the senior man in charge makes an inspection of the factory or the warehouse to see that the stock on hand appears to be in usable or salable condition.

There are two clerical tests relating to inventory quantities which we make in the following cases:

1. The quantities on the original stock-taking sheets are usually transcribed to final inventory sheets used for pricing the inventory. In such cases we make a substantial test of the quantities shown on the original sheets to the final summary in order to satisfy ourselves that all materials counted are shown in the final inventory.

2. As mentioned previously, if a client maintains perpetual inventory records of quantities we make a substantial test of the quantities shown in such record to the final inventory. The quantities shown in these perpetual records should be corrected at the time of a physical count if this count indicates an overage or shortage. Explanations should be obtained for any material overages or shortages brought to light by a physical count since any substantial errors would indicate either inaccurate bookkeeping (such as described in Exhibit 2) or perhaps that stock was being stolen.

When dealing with the receivables I told you about the check which we make to satisfy ourselves that all goods shipped have been billed and vice versa. There is a direct relationship between inventories, receivables and payables. When merchandise is purchased it is charged to inventory and credited to accounts payable. When goods are sold and shipped the inventory of stock is reduced by such shipment but the sale constitutes a debt from the customer to the company. Exhibit 2 attached shows the bookkeeping entries made to record these transactions and charts the flow of the goods. This three-way tie-up of receivables, inventories and payables must be made *at the date a physical inventory is taken.* The chart shows you the effect of this and also what the result would be if—

1. Goods were included in the physical inventory but the related purchase invoice was not set up in the accounts at the date of physical stock-taking;

2. Goods were shipped prior to the physical stock-taking but had not been billed at that date.

The converse of these examples is equally true.

In the comments on the receivables I stated that sales invoices and shipping reports should be matched for the few days preceding the balance sheet date. If a physical inventory is taken at some time other than the balance

sheet date the shipping reports and sales invoices should be matched:

1. At the date of the physical inventory to make sure that there has been a proper cut-off;

2. At the balance sheet date to make sure that all goods shipped prior to the year-end have been billed. If goods have been shipped and not billed the profits would be understated by an amount equal to the excess of the selling price over the cost of such goods.

So far we have dealt only with the existence of inventories and I will now pass on to the basis of valuation. In practically all cases inventories are valued at the lower of cost or market after making proper allowance in the pricing for slow-moving stock, but the meaning of these terms should be understood clearly by all of you.

In a broad sense cost may be determined by any one of four different methods—

1. Cost on a basis of "first-in first-out"
2. Average cost
3. Cost on a basis of "last-in first-out"
4. The basic stock method.

Practically all our clients value their inventories according to either the first or second method. The other two are applicable only in specialized cases and to date have not been accepted by the Dominion income tax department. Therefore I will deal only with the "first-in first-out", and average cost bases.

(1) Cost on a "first-in first-out" basis—This is the actual laid-down cost at the company's plant for the particular goods contained in the inventory which are considered to be those goods most recently acquired. For example, if at the balance sheet date a company has 200 units of product A in its inventory and the last purchase was for 150 units at $2.10 each and the preceding one for 150 units at $2.00 each the cost of the inventory on a "first-in first-out" basis would be as follows:

150 units at $2.10 each	$315.00
50 units at $2.00 each	100.00
	$415.00

(2) Average cost—Average cost is usually calculated on the following basis: At the time a new purchase of each

particular type of goods is made the cost is determined by averaging the cost of the quantity on hand plus the quantity purchased. For example, if a company purchased 100 units of product B at $2.00 each ($200) and at that time had on hand 50 units costing $1.70 ($85) the average cost would be $285 divided by 150, or $1.90 each.

It does not really matter which of the above bases a company adopts in valuing its inventory so long as it is consistent from year to year. It must not change back and forward from one basis to another. Generally speaking "first-in first-out" is more commonly used although supply inventories are usually valued at average cost.

Some of you may think that market means selling price, but this is *not* true in the case of inventory valuation—

(a) For inventories of raw materials and supplies market means replacement cost. The example given above showed that our client held 200 units of product A in his inventory and that his last two purchases had been for 150 units each at $2.10 and $2.00 respectively. Let us assume that the replacement cost at the balance sheet date was $2.10. If this were so, the cost of the inventory as described above would be less than market since he still had in the inventory 50 units costing $2.00 and the other 150 costing $2.10 each. If, however, replacement cost (market) had been $2.00 at the balance sheet date, the market price would be 200 units at $2.00, or $400. As shown above, the cost of these goods was $415 and therefore if a lower of cost or market valuation were used the inventory would have to be reduced by $15.

(b) Goods in process of manufacture and finished goods present a further problem. Inventories should not be valued at a price greater than what will be realized from their sale less marketing expenditures in connection therewith. Therefore market value of finished goods means the lower of replacement cost or selling price less selling expenses. If it is found necessary to reduce the valuation of any finished product to market price the value of similar products in process should also be correspondingly reduced after taking into consideration the cost of processes not yet completed.

The method of verifying inventory prices is explained in detail in the office folder on auditing procedure. We must make a sufficient test of the total value of the inven-

tory to satisfy ourselves that the basis of pricing is correct. We check the pricing of materials and products purchased from outside suppliers by selecting the larger items in the inventory and relating them to the purchase invoices. If detailed purchase records for each material and product are maintained by the client it usually saves a great deal of time to check the prices from such records rather than hunt for the invoices themselves. If we do this we should, however, test the accuracy of the purchase records from a number of actual invoices. The pricing of work in process and finished goods manufactured by the company is frequently most complicated and varies considerably according to the type of cost system used by a particular client. Frequently clients keep card records of costs and we compare the inventory prices with the prices shown by the most recent cost estimates shown on the cards. The preparation of these costs is beyond the scope of this lecture but the senior on the job must satisfy himself that the costs used are reasonable.

It is usually most difficult for us to determine the amount of slow-moving stock included in an inventory. We should, however, follow the procedure which is set out in the office folder which is self-explanatory.

A substantial test of the clerical accuracy of the inventory is always made—the additions are usually checked in detail together with a substantial test of the extensions.

We always obtain a certificate from responsible officials and employees under whose direction or supervision the inventory was determined and valued. A copy of our usual certificate is contained in your folder.

Securities—The existence of securities is determined either by actual count or by confirmation from the depositories (if they are lodged with some outside party for safekeeping). Securities should be counted at the same time as cash; it might be possible to convert the securities into cash to cover up a cash shortage or to purchase securities with cash to cover up a security shortage, and if these were counted at different times such a fraud might remain undetected. If it is impossible to conduct these counts simultaneously the client's safety deposit box or boxes should be sealed on the balance sheet date with tape and sealing wax bearing the impression of the seal of our firm or we should have the bank or trust company certify that no one has had

access to the box from the balance sheet date to the time of our examination.

Canadian bank stocks and stocks of certain other companies are known as "book" or "inscribed" stocks. Such securities are not issued in negotiable form and are transferable only on the records of the issuing company. These stocks must be confirmed by writing a letter to the issuing company.

The details which must be noted when counting securities are set out in the office folder.

In most cases securities are valued at cost. If they represent the temporary investment of surplus funds in negotiable securities they are included on the balance sheet as current assets and in such cases the market value of the securities is ascertained and shown as a note on the balance sheet. If the securities represent permanent investments—such as shares in a subsidiary company—they are shown, not as current assets but in a separate section on the balance sheet.

The verification of investment income was explained to you in a previous lecture and therefore requires no further elaboration.

Fixed assets—Fixed assets consist of land, buildings, machinery, etc., which are required by a company to conduct its operations. The subject of this lecture is not accounting theory but, nevertheless, I want to make sure that you all understand the fundamental difference between the fixed assets and other assets of a company. In general, fixed assets comprise those assets which are held for the purpose of conducting the business as distinct from those which the company holds for the purpose of conversion into cash. Similarly, you should understand the distinction between capital and revenue expenditures. If an expenditure enhances the value of the properties it should be considered a capital expenditure and therefore should be charged to fixed assets. If, however, there has been no enhancement—for example, a maintenance expenditure on existing property—then it should not be considered as an asset but should be included as an expense of operating the business—a revenue expenditure.

We always make a substantial test of the additions to fixed assets shown in a client's records even in the case of clients where we check the detailed transactions for only

one or two months during the year. Similarly, we should scrutinize the operating accounts—particularly such accounts as factory repairs and building repairs—to satisfy ourselves that no expenditures have been charged to profit and loss which should properly be considered as additions to fixed assets. The purpose of these checks should be self-evident to you since if the acquisition of a fixed asset were charged to repairs the assets and profits of the company would be understated and, conversely, if a maintenance expenditure were capitalized the fixed assets and profits would be overstated.

It is difficult to relate the physical existence of the fixed assets with the valuation at which they are stated on a company's books. The valuation of the gross assets is almost always cost and we therefore satisfy ourselves as to the existence and value of new additions by the examination of the related receiving slips and purchase invoices. We should also physically inspect all larger additions.

Through usage and the passage of time fixed assets depreciate in value and therefore provision is made each year for such depreciation. The usual basis of valuing fixed assets is cost less the accumulated reserve for depreciation. We are not engineers or appraisers and it is clearly impossible for us to determine the service life of any individual asset. It is equally obvious that after an asset is worn out it is of no further use to the company and therefore should not be considered an asset. You may ask, therefore, how we know how much depreciation should be provided? The Dominion income tax department has set out maximum rates of depreciation which it will allow annually for the purposes for each different type of fixed asset and these rates are, in the opinion of most manufacturers and engineers, very generous. Therefore, unsound as it may seem, the depreciation provided by most companies is based on the maximum rates permitted by the income tax department even though in practically all cases the normal service life of the asset would be considerably greater than the period during which depreciation is provided on this basis; since we know these rates are generous we accept such depreciation as being adequate.

Since most of our audits are of a recurring nature and are carried on from year to year, I will not explain in this

lecture what we require to support the valuation of the fixed assets when commencing a new audit. On recurring audits we have already determined the valuation of the assets at the end of the previous year and Exhibit 3, attached shows the type of summary which we prepare on all jobs and which will help you to understand the verification work which we perform.

Columns 1 and 5 show the value of the gross assets and the accumulated reserves for depreciation classified according to types of assets at the beginning of the audit period. You will notice that no depreciation is provided on land since production of a company's goods does not reduce its value, and its life is certainly not dependent on usage.

Column 2 shows the additional fixed assets acquired during the period under review and I have already explained to you the method of verification for such items.

Column 6 represents the provisions for depreciation of the assets during the period and I have also explained to you the usual basis for providing such depreciation.

Column 3 represents the value of deductions—that is, the assets disposed of during the period. We should always enquire from the management what assets were disposed of; if they are scrapped in many cases our only source of information is from the management but if assets are sold there should be an entry in the company's books recording the sale, and disposals of this nature should, therefore, come to our attention. All disposals of assets should be taken out of the accounts at the price at which they were originally charged.

Column 7 shows the reserve for depreciation accumulated against the assets disposed of. If an asset is taken out of the accounts so also must the reserve for depreciation accumulated against that particular asset. There will usually be a profit or loss on disposal since it is unlikely that the reserve for depreciation plus the selling price (if any) will be exactly equal to the original cost of such asset. Any profit or loss on disposal is included in the operating statement as a revenue or expenditure item.

Columns 4 and 8 show the balance of the gross assets and depreciation reserves at the end of the period under review. Our verification of the fixed assets is now complete and these final balances are obtained by cross-adding

each side of the schedule and agreeing the resulting balances with the asset accounts and depreciation reserves in the general ledger.

Prepaid expenses and deferred charges—These consist principally of such items as unexpired insurance and prepaid realty taxes.

It is unusual for the expiry dates of insurance premiums which a company pays on its building and contents to coincide with the end of its fiscal year. As most of you know, a great many companies pay insurance premiums for three years in advance and obtain a cheaper rate by doing so. Similarly, municipal taxes are usually paid on a calendar year basis and frequently at the end of a company's fiscal year (which does not coincide with the calendar year) taxes of this nature have been paid in advance. Therefore, the portion of these payments which are unexpired and applicable to future periods is carried on the books as an asset under the caption *"prepaid expenses"*. There are also many other types of prepaid expenses or expenditures deferred to future periods but they are all similar in nature to the two examples described above. We should always make sure that expenses have been deferred on a basis consistent with the preceding year; this may be done by reference to the previous year's working papers.

The existence of prepaid insurance is determined by an examination of the insurance policies and by making sure that the premiums have been paid to a date subsequent to that of the statement which is being checked. Similarly, the existence of prepaid taxes is determined by examination of the tax bills and tax receipts.

Most clients keep an insurance register, listing the various policies held and showing the premium paid on each policy and the amount of such premium applicable to each calendar month and the unexpired portion at the end of the period. If an insurance register is not kept we should get a client to prepare a schedule for our working papers in the form shown in the folder on working papers which you have been given.

We determine the dollar value of the prepaid insurance by checking the client's calculations. For example, if we are reporting upon a statement as at 31st August 1942 and on 1st September 1941 the client had paid $300 for

insurance premiums covering a term of three years, the unexpired portion at the date of the statement would be ⅔ of $300 or $200. Prepaid taxes and other deferred items are calculated in a similar manner.

We should always reconcile the total insurance premiums and taxes paid during a year with the appropriate expense accounts. The following simple formula will achieve this result—

Prepaid at beginning of year		Amount charged to
+ payments during the year	=	expense in operat-
— prepaid at end of year		ing statement

Liabilities

As I stated previously, we must take all precautions necessary to ensure that all liabilities of a company are included in the books. Our verification of the liabilities is, therefore, divided into two sections—

1. Verification of liabilities shown on the books
2. Scrutiny of the various records available to us to see if there have been any omissions.

In this lecture I am going to deal with liabilities in a rather general way and I shall refer specifically only to accounts payable and accrued charges. You were told in a previous lecture about the verification of bank loans which are confirmed by certificate from the bank and which present no difficulty. Income and excess profits taxes are most complex in days such as these and I do not propose to take all the time that would be required to explain them to you in view of the fact that they are usually a problem for the senior on the job in any case.

Accounts payable—The principal source of verification for accounts payable is statements from cerditors and I should like to emphasize their importance. As you know, most creditors render monthly statements and the balances shown by such statements should agree with those shown for each individual creditor in the accounts payable ledger or voucher register (whichever is used). If the statements and ledger balance are not in agreement we must satisfy ourselves that the company's records are correct. By this I do not mean that we should spend a tremendous amount of time checking small differences but if the differences are material we must find out the reason. When dealing with inventories I explained to you the effect on the operating

statement of goods delivered prior to the year-end and included in the physical inventory, the invoice for which was not recorded in the accounts. I also explained to you that this "cut-off" must be checked *at the date of the physical inventory.* If the physical inventory is taken at some date other than the year-end, creditors' statements should be examined at both dates. The most usual cause of differences between creditors' statements and ledger balances is caused by goods invoiced by the creditor before the date of the statement but not received by the debtor until after that date. If this occurred the creditor's statement would show a balance greater than that in the ledger account. When auditing a client's accounts at the end of his fiscal year we cannot ask him to set up the liability for goods which he has not received, but if the difference is at all material we must examine the receiving slip to make certain that such goods were not received prior to the year-end. If such goods were received prior to the year-end, included in the physical inventory and the invoice not set up as a liability, the profits would be overstated by the value of such goods and the accounts payable understated by a similar amount.

Similarly, the ledger balance of a creditor's account might be greater than that shown by his statement. This is most unusual but might indicate that the liabilities were being incorrectly enhanced in order to reduce profits and we should therefore ascertain the reason for this if it occurred.

It is very rare to find that creditors' statements are available for all accounts shown in the ledger. If statements are not available in the case of large suppliers we should either write directly to these creditors requesting confirmation of the balance or ask the client to obtain a statement.

We must, of course, agree the general ledger control account with the balance of the individual creditor's accounts as shown by the accounts payable ledger or voucher register.

Accrued charges—Accrued charges are exactly the opposite of prepaid expenses. I shall use the example of realty taxes to explain this. If a client ends his fiscal year on 28th February it is unlikely that he has received his tax

bills or paid the taxes for the current calendar year. However, two months of such taxes should be included in his expenses and liabilities and therefore the estimated taxes for these two months should be accrued. Similarly, if a client pays his employees weekly, the end of his fiscal period frequently does not coincide with the end of a pay period. Therefore there is a liability for the wages earned by the employees but not paid for that portion of the uncompleted pay period falling within the fiscal year. Such accrued wages should be verified from the payroll.

I told you previously that if a client deliberately wishes to understate liabilities it is frequently most difficult to detect omissions of this nature. You will see from my remarks above that creditors' statements are one source which we use to look for such amounts but this is not foolproof because the client could simply withhold the statement and if no balance were shown in the ledger we would be unaware of the omission. There are several other avenues open to us:

(a) Vouchers for subsequent months. Examine vouchers for the months subsequent to the year-end and ascertain if any of these are dated and applicable to the period which we are auditing. If we find vouchers dated prior to the end of our audit period for the purchase of services, the liability should be included in the accounts. If such vouchers related to goods purchased we should check the receiving slips to see if they were received before the year-end and, if so, the liability should be entered. It is not necessary, however, to make adjustments for relatively small liabilities not entered in the accounts if they will not materially affect the earnings or balance sheet position. If the physical inventory is taken at some date other than the year-end and statements from large suppliers are not available at the date of the physical inventory, we should also match the receiving slips and purchase invoices relating to such suppliers for the subsequent month to make sure that all such purchases were included in the liabilities at the date of the physical inventory.

(b) Cheque register for subsequent month. If a client deliberately wished to understate his liabilities he would not present to us for examination the applicable voucher or vouchers. Therefore, we should enquire into large pay-

ments shown in the cheque register for the succeeding month to see if any of these related to our audit period.

(c) Comparison of expense accounts with previous years. This is really part of the profit and loss verification to which I will refer later but any substantial reduction in an expense account might indicate an undisclosed liability.

(d) Analysis of interest paid account. One reason for analyzing interest expense account is to ascertain that the company is not paying interest on a loan not set up in the books.

(e) Lawyers' bills. There might be a lawsuit in process which had not been brought to our attention and for which no provision had been made in the books. If legal advice had been sought in this connection some reference to it would probably be made in the lawyer's account.

(f) Bank confirmations. On our standard bank confirmation form we request the bank to notify us of all liabilities of the client to the bank and liabilities not entered on the books are sometimes disclosed in this manner.

(g) Comparison with accrued expenses shown in the previous year's working papers. In particular, we should consider whether provision has been made in respect of the following:

1. Legal fees
2. Accrued wages and salaries (already referred to above)
3. Accrued commissions and travelling expenses
4. Bonuses and profit sharing plans
5. Workmen's compensation
6. Accrued water, rent, light, etc.
7. Interest accrued on such items as bank loans, bonds, mortgages, advances from directors or employees, etc.

We always obtain a liability certificate from senior officers of the company that the records reveal all liabilities. This certificate should always bear the signature of the company's most senior official since he might be aware of certain liabilities which had not been divulged to the secre-

tary-treasurer or accountant. A copy of the form which we usually use for this certificate is included in the office folder on auditing procedure.

Bonds and debentures payable—The issue of bonds or debentures must be authorized by by-law of the company and in practically all cases there is a trust deed covering the issue which sets out the security pledged and the terms of the bonds. We confirm the existence and valuation of such a liability by certificate from the trustee and the usual form of this confirmation is shown as an exhibit in your office folder. If there is no trustee the bonds outstanding should be verified from the debenture register maintained by the client.

Capital stock—The authorized capital stock is verified by examination of the letters patent or supplementary letters patent. The issued capital is verified in two ways depending whether the company is its own transfer agent or employs an outside concern to do this work.

1. If a company acts as its own transfer agent the issued capital is verified by agreeing the stock certificate stubs with the trial balance of the share ledger, the total of which must be agreed with the balance in the general ledger.

2. If the company employs an outside transfer agent or registrar the number of shares outstanding is confirmed by certificate.

Earned surplus—The verification of additions or deductions to surplus arising from earnings is dealt with below under the verification of the operating accounts.

Transactions occurring during one accounting period but applicable to a prior period should be shown in the surplus account since they do not apply to the current year's operations. In practice it is usual to record only important items in this manner and therefore small adjustments are not made through the surplus account but are included in the results of the year's operations. Such adjustments made through surplus may be either additions or deductions, depending on whether they are revenue or expense items.

The most usual deduction from surplus is dividends. These are declared by minute of the Board of Directors and the method of verifying the correctness of the individual

payments to shareholders was explained to you in a previous lecture.

The above remarks refer to earned surplus. Some companies also have a capital surplus arising from appraisal of the fixed assets or from the redemption of preferred shares but since such an account is the exception rather than the rule we need not dwell on it further in this lecture.

Verification of the Profit and Loss Account

I shall deal with the verification of the profit and loss items in a very broad sense since the individual items contained in the operating accounts vary greatly according to the type of business in which a company is engaged.

The most significant figures in the operating statement are—

1. the gross profit (or loss), and
2. the net profit (or loss).

1. **Gross profit**—This is the excess of sales over cost of the goods sold. We should make a careful analysis of the reasons for the change in both the dollar value of the gross profit from the previous year and also the ratio of gross profit to sales. For example, if the gross profit margin—that is the ratio of gross profit to sales—has increased, it must mean either that selling prices have increased, costs have been reduced or that a combination of the two has taken place. If the gross margin were reduced the converse should be true. It is extremely important that we reconcile the figures with the facts and if these are contradictory we must, under all circumstances, obtain a satisfactory explanation since it might be possible that the company was fraudulently trying to inflate or deflate sales or profits. The details of the verification work performed on sales, cost of sales and gross profit is shown in the office folder on auditing procedure which also enumerates the more important factors which would be likely to affect these accounts.

2. **Net profit**—The net profit is the total profit after deducting all expenses including income and excess profits taxes.

In all cases we should compare the individual expense accounts with those of the previous year and account for any wide variations (including a comparison of the expense

accounts included under cost of sales). For example, an analysis of a large increase in factory repairs account over the previous year might disclose that the purchase of additional equipment, which should properly be capitalized, had been improperly charged to repairs expense account. As mentioned previously, an analysis of the interest paid account might reveal a payment of interest on a loan excluded from the liabilities. I certainly do not mean to imply that clients as a general rule purposely classify items improperly, because such is not the case. Usually if there are wide variations we are able to obtain satisfactory explanations. I should, however, like to stress most strongly that we must satisfy ourselves that any large variations must be properly explained as it is quite possible that they might indicate improper practice, or exclusion of liabilities from the accounts.

The verification of sundry income was explained to you in another lecture. Our principal purpose in the verification of this item is to satisfy ourselves that *all* sundry income has been included—we should check from the source of the income to the ledger and *not* from the ledger account to the source.

If we undertook our verification in this latter manner we might overlook some of the sources of income altogether.

A most important deduction from net profit is the provision for income and excess profits taxes but, as I said before, this is beyond the scope of this lecture.

The work which will be assigned to you in the verification of the profit and loss account will probably consist mainly of the preparation of expense analyses. This does *not* consist of a transcription of the ledger account and it is important that the analysis be prepared in an intelligent manner. Exhibit 4, attached shows the correct way of analyzing an expense account.

We have covered a great deal of ground today and I have tried to omit as much detail as possible in order that you could get a general background of the fundamental purposes of the work which we do. This lecture is by no means all inclusive, but if it has helped you to obtain a clearer understanding of balance sheet verification its purpose has been achieved.

EXHIBIT 1

ASSETS
Debit balances—except as noted

Current
- Cash on hand
- Petty cash funds
- Cash in bank
- Accounts and bills receivable
  - Reserve for bad debts (Cr.)
- Inventories
- Temporary Investments (marketable)
- Life insurance (cash surrender value)

Fixed
- Land
- Buildings
  - Reserve for depreciation (Cr.)
- Machinery and equipment
  - Reserve for depreciation (Cr.)
- Automobiles and trucks
  - Reserve for depreciation (Cr.)

Other
- Investments (not readily marketable and/or controlled companies)
- Prepaid expenses
- Trademarks and leases
- Goodwill

LIABILITIES
Credit balances—except as noted

Current
- Bank loans
- Accounts and bills payable
- Taxes payable and accrued
- Wages and other accrued charges

Deferred
- Bonds payable
- Mortgages payable

Reserves
- General reserve
- Reserve for contingencies

Proprietorship
1. Proprietor's equity
   or
2. Partners' capital accounts
   or
3. Capital and Surplus
   or
   Deficit (Dr.)

PROFIT & LOSS SURPLUS

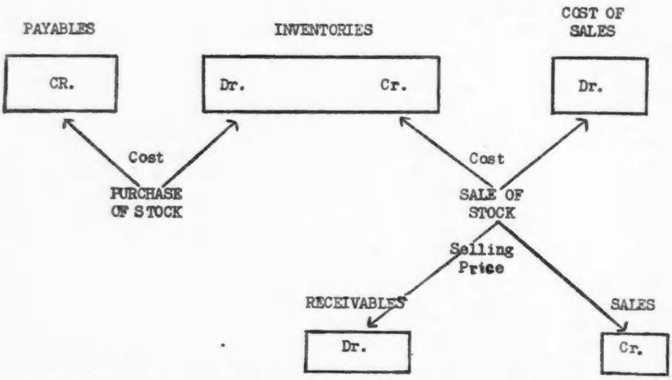
Revenue (Cr.)
- Sales
- Investment income
- Miscellaneous income

Expense (Dr.)
- Cost of goods sold
- Selling expense
- Warehouse and delivery expense
- Administrative and general expense
- Financial charges
- Provision for taxes on income

Distribution of profits (Dr.)
1. Proprietors' drawings
   or
2. Partners' drawings
   or
3. Dividends

EXHIBIT 2

RELATION OF INVENTORIES, RECEIVABLES AND PAYABLES



In theory a physical inventory should always be in agreement with the book inventories. If it is not in agreement the books are adjusted to the physical inventory, at the time a physical inventory is taken.

1. Relation between inventories and accounts payable

(a) Goods received prior to date of physical inventory, the invoice for which was not set up in accounts payable until after that date.

The ABC Company ends its fiscal year on 31st December *and a physical inventory was taken on that date*, the value of which was $100,000; this was $5,000 in excess of book inventory. The books were adjusted to the value shown by the physical inventory and the overage of $5,000 was credited to revenue for the year.

On 29th December merchandise costing $5,000 was received, but the invoice was not set up on the company's books until 5th January of the next year. However, since the goods were on hand at 31st December they were included in the physical inventory; this accounts for the overage of $5,000.

Thus (1) profits were overstated by $5,000—the overage credited to revenue was incorrect

(2) liabilities were understated by $5,000—the purchase was included in the inventory but not set up on the books.

(b) Goods received prior to end of fiscal year, but subsequent to date physical inventory was taken, the invoice for which was not included in accounts payable at end of fiscal year.

Suppose that the ABC Company *had taken a physical inventory on 30th November* and that all receipts and shipments of merchandise prior to that date were properly recorded in the books. The inventory at 31st December was determined by adjusting the physical inventory at 30th November for receipts and shipments of stock during the month of December as shown by the books.

The merchandise costing $5,000 received on 29th December was again not recorded in the books until 5th January of the next year.

In this case—

(1) the inventory was understated by $5,000 since the receipt of 29th December was not included in the December receipts as shown by the books.

(2) liabilities were understated by $5,000—the purchase was not recorded in the books.

(3) the profit and loss account was not affected by the transaction.

2. Relation between inventories and accounts receivable

(a) Goods shipped prior to date of physical inventory but not billed.

Suppose the circumstances were as follows:

(1) a physical inventory was taken on 31st December, the value of which was $100,000

(2) this was $5,000 less than the book inventory and the shortage was charged against the year's revenue (included in cost of sales).

(3) goods costing $5,000 were shipped on 29th December and invoiced to the customer on 5th January of the next year at a selling price of $6,000.

The result of this would be—

(1) sales and profits were understated by $6,000—the amount of the sale which should have been billed in December.

(2) accounts receivable were understated by $6,000—the amount of the unbilled sale.

(b) Goods shipped prior to end of fiscal year, but subsequent to date physical inventory was taken, and not billed to customer until after end of fiscal year.

Suppose that as in 1(b) above the physical inventory was taken 30th November and that the inventory at 31st December was determined by adjusting the November inventory for receipts and deliveries during December.

The shipment of goods costing $5,000 was again made on 29th December and invoiced on 5th January of the next year at a selling price of $6,000.

The result would be—

(1) the inventory was overstated by $5,000 since the shipment of 29th December was not included in the December shipments as shown by the books.

(2) cost of sales was understated by this same $5,000—the cost of the shipment.

(3) accounts receivable were understated by $6,000—the amount of the unbilled sale.

(4) sales were understated by $6,000.

(5) profits were understated by $1,000—the excess of the selling price over the cost of the unbilled shipment.

EXHIBIT 3

FIXED ASSET SUMMARY

	ASSET				Reserve for Depreciation				
	Balance 31st August 1941 (1)	Additions (2)	Deductions (3)	Balance 31st August 1942 (4)	Balance 31st August 1941 (5)	Provision for year Rate	Amount (6)	Deductions (7)	Balance 31st August 1942 (8)
Land	$ 25,000	$	$	$ 25,000	$		$	$	$
Buildings	$ 75,000	5,000		$ 80,000	15,000	2½%	2,000		17,000
Machinery	150,000	20,000	10,000	160,000	85,000	10 %	16,000	8,000	93,000
Automobiles	8,000		2,000	6,000	4,400	20 %	1,200	1,700	3,900
Furniture and fixtures	12,000	2,000		14,000	8,000	10 %	1,400		9,400
	$245,000	$27,000	$12,000	$260,000	$112,400		$20,600	$ 9,700	$123,300
	$270,000	$27,000	$12,000	$285,000	$112,400		$20,600	$ 9,700	$123,300

NOTE re disposal of assets	Asset value	Accumulated depreciation	Net value	Realized on disposal	Profit on sale	Loss on sale
Machinery	$10,000	$8,000	$2,000	$1,200	$	$ 800
Automobiles	2,000	1,700	300	500	200	
	$12,000	$9,700	$2,300	$1,700	$ 200	$ 800

Net loss of $600

EXHIBIT 4

INTEREST

GENERAL LEDGER ACCOUNT

Date		Fol.		Dr.	Cr.		Bal.
Jan.	Bank loan	V.R.	2	$100	$		$
	Accounts receivable	J.	5		15	Dr.	85
Feb.	Bank loan	V.R.	8	140			
	Smith mortgage	C.R.	16		20	Dr.	205
Mar.	Bank loan	V.R.	14	80		Dr.	285
Apr.	Bank loan	V.R.	20	40			
	Accounts receivable	J.	26		25	Dr.	300
May	Jones loan	V.R.	38	200			
	Accrued bond interest	V.R.	38	80		Dr.	580
June	Bond interest	C.R.	58		100	Dr.	480
July	Accounts receivable	J.	44		10	Dr.	470
Aug.	Smith mortgage	C.R.	85		20	Dr.	450
Dec.	Bond interest	C.R.	140		100	Dr.	350
				$640	$290		

ANALYSIS

Interest paid:		
Bank interest	$360	
J. Jones loan (director)	200	$560
Interest received:		
Bond interest received	$200	
Less accrued at time of purchase of bonds	80	
	$120	
Mortgage interest	40	
Interest charged to customers on overdue accounts	50	210
As per general ledger	Dr.	$350

GLIMPSES OF CURRENT ACCOUNTING LITERATURE

A Summary Prepared by John Douglas Campbell,
Chartered Accountant

BULLETINS

(1) Cost Accounting

Bulletin No. 9, Volume XXIV, 1st January 1943, published by the National Asociation of Cost Accountants (385 Madison Avenue, New York) covers the effect of the recent provisions made in the 1942 Revenue Act (U.S.) as to pension fund contributions and the renegotiation of contract prices.

Pension Plans—Victor H. Stempf in "Pension Plans" presents a general outline of the general theory underlying the creation of pension plans stressing the relationships at present existing to the tax laws. The various types of pension plans are outlined and the suggestion is offered "that type of plan should be selected which seems best suited to the needs of the individual case and the plan selected should then be tailor-made to fit the immediate requirements."

Renegotiation of Contracts—Carman G. Blough in an article "Changes in the Federal Laws Which Affect the Renegotiation of War Contracts" discusses the general nature of the renegotiation provisions contained in the 1942 Revenue Act (U.S.).

Bulletin No. 10, Volume XXIV, 15th January 1943, covers two current problems in the field of methods which have arisen from shortages caused by the present war emergency. The first article deals with the broad problem of an overall method of controlling the allocation of existing supplies of strategic materials whereas the second article presents a suggested answer to the more specialized problem of a manual method of payroll accounting so designed to overcome the present problem of office equipment shortages.

Controlled Materials Plan—Henry C. Chapman in "The Controlled Materials Plan" presents a non-technical description of the plan which has been adopted in the United States to replace the former Production Requirements Plan in meeting the priorities problem. "Fundamentally the purpose of the Controlled Materials Plan is to assure a balance

between the supply and demand for materials. It has been devised to ensure the availability of controlled materials in the quantity and form and at the time required by approved production programs and schedules." The emphasis is placed on the necessity of a balanced national program in order to procure an "all-out war effort."

The detailed operation of the plan is presented illustrated by certain specific practical examples. Possible problems which are to be met in implementing the plan are discussed. "The plan itself must be fluid and changes will have to be made from time to time in order to cope with special conditions."

Payroll System—Frank D. Burk in "A Manual Payroll System for Present-Day Needs" outlines the steps which were taken by one company in meeting the problem of payroll accounting which presented itself when production was increased from one to three shifts in that the limited office equipment formed a virtual bottle-neck.

In discussing the use of mechanical equipment in this particular problem Mr. Burk states "we discarded this method because the work converged into a bottle-neck where it cleared through the machine operator . . . We felt that we could not force all of the work through a machine in the time available."

Realizing that under the conditions present the payroll preparation must progress step by step through the department, a manual system of payroll accounting was devised. A detailed explanation of the simplified plan is outlined supported by exhibits illustrating the nature of the records prepared. The suggested plan is based on a maximum utilization of the original payroll information prepared particularly from the standpoint of summarization.

(2) Auditing

Restricted Examination—The Committee on Auditing Procedure of the American Institute of Accountants in Statement No. 12 on Auditing Procedure presents "The Auditor's Opinion on the Basis of a Restricted Examination No. 3) Face Amount Certificate Companies."

Against a background of a general outline of the functions of face amount certificate companies the committee expresses an opinion that an examination which excludes

consideration of the amount of reserves carried and the propriety of the accounting principles underlying their determination affords an inadequate basis for even a qualified opinion as to the fairness of the financial statements.

Accounts Receivable—Statement No. 14 on Auditing Procedure issued in December 1942 and published in the January 1943 issue of *The Journal of Accountancy* (13 East 41st Street, New York) covers "Confirmation of Public Utility Accounts Receivable."

The problem discussed covers the extent of confirmation necessary in respect to Public Utility Accounts Receivable in order to enable an unqualified opinion to be presented.

In presenting their conclusions a subdivision was made in the opinion expressed as between the "large" accounts and the "mass" or small accounts. The opinion presented in essence was that the current procedure of complete circularization should be applied to the large accounts whereas the small accounts, assuming an efficient system of internal check to be in existence, would be subjected to merely a test circularization.

(3) Accounting

Refundable Portion Excess Profits Tax—Bulletin No. 17 issued in December 1942 by the Committee on Accounting Procedure of the American Institute of Accountants on "Post-War Refund of Excess Profits Tax" is published in the January 1943 issue of *The Journal of Accountancy*.

The balance sheet and income statement treatment is essentially the same as that suggested by The Dominion Association of Chartered Accountants weighted by the provisions of the U.S. laws.

"(1) In the balance sheet the amount of excess profits tax payable (without deduction for the so-called post-war credit . . .) should be shown as an accrued liability in the current liability section; the amount of such post-war credit . . . should be shown . . . as a non-current asset.

"(2) In the income statement, effect should be given to the full amount of excess profits tax, the amount of the post-war credit . . . with appropriate disclosure as to each such amount."

Bond Discount and Premium—Accounting Research Bulletin No. 18 supplements No. 2 in this series in which the alternative treatments of disposing of unamortized discount and issue cost and redemption premium on bonds refunded are set out. The new bulletin discusses the treatment of the reduction in income taxes resulting from such refundings.

ARTICLES

(1) Income Statement

William A. Paton in an article "Adaptation of the Income Statement to Present Conditions" published in the January 1943 issue of *The Journal of Accountancy* discusses the major changes which are in the process of taking place in the form of the income statement in meeting present conditions together with possible additional changes which might be implemented.

In covering the general question the suggestion is offered "in the case of the general income statement detail and elaboration should not be carried beyond the point of effective presentation in view of the complexity of the enterprise and the nature of the interested group."

Several points are discussed specifically and suggestions are offered as to their possible treatment. The more significant of the points covered deal with the reporting of revenue, use of the term gross profit, nature of losses, and the treatment to be accorded income and excess profit taxes. An example of a proposed simplified form of income statement is presented as a conclusion.

"Accordingly, for the condensed general income statement, it is recommended that sales and all other revenues and earnings be combined to produce a total of revenue from which deductions may be made."

In covering the use of the term "gross profit" Mr. Paton as on numerous other occasions describes it as a purely artificial caption on the grounds that "all necessary costs of operation are on essentially the same level. There is no warrant for the view that certain types of costs have priority or right of way over other charges . . . there can be no profit . . . until all costs have been taken into account."

The general nature of the income and profits taxes is reviewed and it is stated that under prevailing rates "the

artificiality of treating income and profits taxes as a preliminary distribution of corporate profits becomes evident. There simply are no profits . . . until the processes by which the total government recovery is determined have been fully applied." The suggestion offered is that all revenue which passes through the corporate hands and then reverts to the governmental customer by means of the effect of the tax structure should be set out as a separate subdivision under "Expenses, Losses and Taxes."

(2) Ration Banking

Raymond J. Hannon in an article "Ration Banking" published in the January 1943 issue of *The Journal of Accountancy* explains the purpose and operation of a system of ration banking designed to facilitate the handling of ration coupons.

The basic plan underlying the suggested system lies in utilizing the present banking facilities in which coupons (ration) will be treated similar to the present deposit currency.

"Under the ration-banking plan, a retailer of rationed items is required to open a ration account in a bank in much 'the same manner as a checking account is opened'." The retailer makes regular deposits of coupons received in the course of business and utilizes transfer vouchers for drawings made against the account in replenishing his stocks of rationed commodities.

(3) Valuation of Inventories

A synopsis of the report made by the Subcommittee on Auditing Procedure of the American Institute of Accountants dealing with the question of inventory valuation is presented in the January 1943 issue of *The Journal of Accountancy.*

The background of the report is based on replies received from questionnaires sent out covering this particular problem.

In preparing the questionnaire the subcommittee approached the problem from the standpoint of the item of cost of sales in the income statement rather than of inventories in the balance sheet. The general problem based on this "tenet" resolved itself into ascertaining whether or not the "affinity" between reproductive costs and selling prices governed the type of inventory base used.

Although theoretically a quick affinity should result, other things being equal, in the adoption of the "last-in first-out" basis shading to the average stock basis and then to the first-in first-out basis as the rate of responsiveness declined, the questionnaires returned (too few to form a basis for a general deduction) did not indicate exactly this pattern.

(4) Financial Statements in Wartime

George N. Farrand in an article "Wartime Problems of Financial Statements," published in the January 1943 issue of *The Journal of Accountancy,* covers the general problem under the sub-headings of the Income Statement and the Balance Sheet.

In discussing the general problem it is pointed out that although "tentativeness is the prevailing characteristic of financial statements in wartime, there are variations in the degree of tentativeness applicable to the individual items comprising such statements." Accordingly the goal of the accountant is set out to be the development of the best obtainable presentation of each situation. Special emphasis is placed on adequate and full disclosure of all material facts.

Special problems concerning the income statement are discussed involving the questions of renegotiation, cost plus fixed fee contracts both as to income realization and presentation, accelerated depreciation and special war reserves.

The balance sheet discussion is concerned essentially with the proper presentation of relationships existing between the company and the government involving such items as advances, contract agreements and tax liability.

(5) Social Security

The Accountant (London) in three leading articles appearing in the issues of the 12th, 19th and 26th December 1942 covers a discussion of the recent Beveridge Report under the heading "A Plan for Social Security."

The main features of the "Plan for Social Security" as set out in the Beveridge Report is a scheme of social insurance against interruption or destruction of earning power and for special expenditures arising at birth, marriage or death—"To make want under any circumstances unnecessary."

The scheme embodies six fundamental principles—flat rate of subsistence benefit; flat rate of contribution; unifi-

cation of administrative responsibility; adequacy of benefits; comprehensiveness and classification. It is based on three fundamental assumptions—an adequate scheme of children's allowances, a complete medical service and the maintenance of unemployment at a lower level than it has ever been in our time.

Each of the fundamental assumptions mentioned is discussed in detail as to its possible attainment and whether having attained them that the result will be that anticipated.

The general problem of incentive is raised and doubts are expressed as to whether or not such a scheme of social security is not calculated in the long run to weaken the national fibre.

(6) Last-In First-Out (Lifo)

Dr. Richard S. Meriam in an article "Lifo not All-sufficient Way of Correcting Company's Accounts," published in the January 1943 issue of *The Controller* (1 East 42nd Street, New York), discusses the nature and application of the Lifo basis of inventory valuation to present day conditions.

The aim of the "Lifo" basis is set out as a means of providing an up-to-date figure for the profit and loss statement by excluding inventory profits which are not in reality realized in that they are required to replace the inventories at the higher prevailing prices. "Broadly speaking the 'Lifo' method gives you a good current picture for your profit and loss statement at the expense of including in your balance sheet an out-of-date figure."

Three arguments are advanced as favouring the use of the "Lifo" method. "First, this method gives better information to the stockholders; second, it permits the executives of the company to make sound decisions because they can work with current information; and finally it provides a more equitable method of ascertaining taxable income."

Of the three arguments the first two are dismissed with little discussion. It is pointed out that these same objectives can be obtained through the use of alternative procedures (footnotes to the statements). Special stress is placed on the last argument which is discussed in detail. "My argument for this method is that it cuts out inequitable taxes. In other words, if 'Lifo' is not admitted as

a way of determining taxable net income, the income tax is a kind of a capital levy. It takes profits on paper that are not really earned."

(7) Consolidated Statements

The recent decision given by the American courts in the case *Cintas vs. American Car and Foundry Company* which involves the question of consolidated returns is discussed by George O. May in an article appearing in the December 1942 issue of *The Journal of Accountancy.*

The case revolved primarily upon the point as to how profits or losses of wholly-owned subsidiary companies are to be treated from an holding company income standpoint. The courts ruled that income of the wholly-owned subsidiary represented income of the holding or parent company only when it had been received in the form of dividends and that the consolidated statement represented a mere "figment."

In discussing the court decision Mr. May first sets out clearly and concisely the general nature of the consolidated statement and under what conditions its use may be justified logically. This is followed by a discussion of the pros and cons of the specific question under consideration. "Those who favour deferring recognition of income in such cases until formal declaration, do so on purely prudential grounds and with the determination of the cumulative total of available profits in mind as the primary object of the accounting."

Robert H. Montgomery in a short article appearing in the same issue of *The Journal of Accountancy* refers to the evidence which was given by certain of the accountants for the complainant in which they concurred that a consolidated balance sheet "is nothing more than an imaginative figment, for there is actually no individual business having the assets and liabilities depicted by it."

In commenting on the evidence Mr. Montgomery states "We may never be too old to learn but after forty year's adherence to the 'figment' I decline to change my view. The profession may be going legalistic but I refuse to go along."

(8) Municipal Auditing

Fladger F. Tannery in an article "Independent Municipal Auditing" published in the October 1942 issue of *The Accounting Review* discusses the underlying reasons why

auditing in the municipal field has failed to keep pace with auditing in the industrial field. This is followed by an outline of practical ways and means by which the situation may be remedied.

In summing up the major causes lying behind the lack of progress in the municipal auditing field Mr. Tannery states that it is due to the failure of the public officials, the layman, and the public accountant to have a common concept of what an independent audit is and what should be accomplished by it.

The main purposes served by the independent audit are outlined followed by the presentation of a series of twenty independent audit standards applicable in the municipal audit field. Special stress is placed on the significance of the independent opinion expressed by the independent municipal auditor both from the standpoint of the community as well as from the standpoint of the public official.

TABLE OF EXCHANGE RATES

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	30th January 1943	*15th February 1943*
U.S. Dollars	10-11% P.	10-11% P.
Sterling	443-447	443-447
Australian Pounds	358½	358½
New Zealand Pounds	360	360
South African Pounds	443	443
British West Indies—Dollars	9270	9270
India—Rupees	3356	3356
Hong Kong—Dollars (Custodian rate)	2781	2781
Straits Settlements—Dollars (Custodian rate)	5226	5226
Sweden—Kronor	2635	2635
Switzerland—Francs	2569	2569

Note: The above currencies are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies and sundry British Empire—Canadian cents per 100 units.

DOMINION INCOME TAX T.4. RETURNS FOR 1942

By Laurence C. Crawford, Chartered Accountant, Niagara Falls, Ont.

THE attention of all accountants is called to the changes in Section 39 of the *Income War Tax Act,* whereby employers' returns (T.4.) for 1942 are to be submitted on or before 15th October 1943. In making these T.4. returns it will be necessary to show tax deductions as follows:

(a) National Defence Tax deducted during 1942 up to 31st August 1942.

(b) Income Tax deducted from 1st September 1942 to 31st August 1943.

In order to simplify the work necessary to complete these forms, I suggest that, as early in 1943 as can be arranged, all available information should be assembled as far as possible, i.e., all the information necessary to complete T.4. supplementary sheets (using 1941 T.4. supplementary form for guidance) including the defence tax and income tax deductions during 1942.

After 31st August 1943, it would then be necessary to add the amount of tax deducted from 1st January 1943 to 31st August 1943 to the 1942 income tax deduction already shown on the previously prepared lists in order to complete information required for preparation of the T.4. supplementary forms. In this connection, of course, it would be necessary to add to the list of employees already prepared, information necessary to complete returns for those employees who were not engaged until 1943, since income tax would be deducted from such employees, to be applied against 1942 income tax.

The merit of this proposal lies in the fact that it spreads out the work necessary in compiling the information required and in the reconciliation of wage rolls for 1942 before the final preparation of the actual returns between 1st September and 15th October 1943.

MONTHLY INSTALMENT PAYMENT OF TAX BY CORPORATIONS

IN a reference to monthly instalment payment of tax by corporations, under the head of "General Notes" in THE CANADIAN CHARTERED ACCOUNTANT of October 1942, there was possible confusion as to the timing of the payments. Actually they commence, on an estimated basis, when six months of the corporation's fiscal year have expired, continuing on that basis for eight months, following which period adjusted payments are to be made for four more months. Thus the payment of tax is spread over a period of twelve months commencing mid-way in the fiscal year and ending six months following its close.

For the benefit of those who may not be familiar with the actual wording the Section 48 (4) of the *Income War Tax Act,* which is the part covering this matter, it is quoted in full herewith:

Every corporation shall pay all taxes which it is liable to pay in any taxation year under any of the provisions of this Act, except sections nine B, twenty-seven and eighty-eight thereof, by instalments payable on or before the last day of each month during the twelve month period ending six months after the close of such taxation year, as follows:

(a) during the first eight months in such period, an amount equal to one-twelfth of such tax as estimated by it on its income for the year last preceding the taxation year or on its estimated income for the taxation year at the rate for the taxation year;

(b) during the last four months in such period, one-fourth of the amount by which the tax payable as estimated by it on its income for the taxation year at the rate for the taxation year, exceeds the aggregate of

(i) the amounts paid under paragraph (a) of this subsection, and

(ii) the amounts deducted during the taxation year under subsection one of section ninety-two of this Act from interest or dividends forming part of its income, and if, after examination of any corporation's return under section fifty-three of this Act, it is established for the purposes of this Act that the instalmens paid by such corporation in any year under this section amount, in the aggregate, to less than the tax payable, it shall forthwith after notice of assessment is sent to it under section fifty-four of this Act, pay the unpaid amount thereof together with interest thereon at five per centum per annum from the day four months after the end of the taxation year until the date of payment.

Dominion Prize Winners
in the December 1942 Examinations of
The Provincial Institutes of Chartered Accountants

Robert W. Meanwell (Ontario) — Saul F. Finesilver (Quebec) — Marius Laliberté (Quebec)

Robert W. Meanwell, Windsor, a candidate of the Institute of Chartered Accountants of Ontario, was awarded the Gold Medal and cash prize of $50 of The Dominion Association of Chartered Accountants for winning first place in Canada in the final examination conducted in December 1942 throughout the Dominion by the Provincial Institutes of Chartered Accountants. Mr. Meanwell is now enrolled in the officers' training course at Brockville.

Saul F. Finesilver, Montreal, a candidate of the Society of Chartered Accountants of the Province of Quebec, obtained the second highest standing in the Dominion final examination and was awarded the Silver Medal and cash prize of $25 of The Dominion Association of Chartered Accountants. Mr. Finesilver is now serving in the Royal Canadian Air Force.

Marius Laliberté, Quebec City, a candidate of the Society of Chartered Accountants of the Province of Quebec, won the Silver Medal and prize of $25 of The Dominion Association of Chartered Accountants for standing first in the December 1942 intermediate examination of the provincial Institutes.

PROVINCIAL NEWS

ALBERTA

The Institute of Chartered Accountants of Alberta announces that, subject to the formal approval of the General Faculty Council of the University of Alberta, the following are the successful candidates of the Institute in the December 1942 examinations:

Primary—J. B. Fisher, B. C. Grineau, K. S. Holman, H. A. Kerr, M. F. Mackenzie, J. C. Pepperdine, J. C. Rudolph, G. S. Stark and A. E. Welsh.

Intermediate—W. A. Davis, J. B. Macmahon, J. C. Miller, B. C. Tanner, W. K. Tanner and W. L. C. Wallace.

Final—A. P. Friesen, E. King, S. F. Marshall, J. M. Meikle and A. B. Ross.

J. H. Phillips was successful in Final Law.

In the primary examination J. C. Rudolph is eligible for the book prize; in the intermediate examination W. L. C. Wallace is eligible for the book prize and in the final examination A. P. Friesen is eligible for the book prize.

BRITISH COLUMBIA

The following candidates of this Institute were successful in the December 1942 uniform examinations in the subjects of Accounting and Auditing of the Provincial Institutes of Chartered Accountants. The names are arranged in order of merit.

Final—A. M. Reid, L. E. Cuthbertson and R. D. Young.

Supplementals—A. H. Affleck, R. M. Bain and J. E. Robertson.

Granted Supplementals—S. S. McLaren (Final Accounting II & III), W. T. Powers (Final Accounting II & III) and F. J. Vulliamy (Final Auditing).

Intermediate—W. G. Briggs, J. M. Ross, M. W. Angus and J. C. Moore.

MANITOBA

The Institute of Chartered Accountants of Manitoba announces that the following are the successful candidates of the Institute in the uniform examinations of December 1942 set throughout the Dominion by a joint committee consist-

ing of representatives of the provincial Institutes of Chartered Accountants in Canada.

Final: Halldor S. Bardal, Thomas Edward Brown, John William Crowe, Roy Arthur Dingle, Henry Harold Floyd, Alexander M. Gammie, James Arthur Hillman and Rothero W. Thacker. Alexander Tadman has supplemental standing in Accounting.

James Arthur Hillman ranked highest amongst Manitoba candidates and was awarded the Institute prize of $100. Halldor S. Bardal was awarded a prize of books.

Intermediate: Archibald Douglas Brown, Gordon Kinsella Gage, Frederick Pratt, Claude Alan Rampton, Harold Sigurdson, Kenneth Hugo Smith, Angelo Joseph Tonelli and Lorne Andrew Turner.

Gordon Kinsella Gage, who secured first place amongst the Manitoba candidates, was awarded the W. A. Henderson Silver Medal and a scholarship of the value of $50.

NOVA SCOTIA

The Institute of Chartered Accountants of Nova Scotia announces that the following candidates have been successful in the uniform examinations of the provincial Institutes for the year 1942:

Primary: J. A. Conway, Ralph Davis, G. A. Finlay, J. A. Manning and W. C. Smith.

Final: E. M. Davison, E. F. J. Flemming, R. W. Manning and H. A. Renouf.

ONTARIO

The Institute of Chartered Accountants of Ontario announces the following results of the examinations in the primary, intermediate and final grades held in December last. Candidates in the intermediate and final grades wrote the uniform examinations of the provincial Institutes of Chartered Accountants. Mr. R. W. Meanwell of Windsor, now enrolled in the officers' training course at Brockville, won the gold medal awarded by the Board of Examiners-in-Chief of the provincial Institutes for the highest standing in Canada in the accounting and auditing papers of the final examination.

Primary: Norman Allentoff, C. L. Anger, J. M. Bagnall, L. G. Belyea, K. A. Bloxham, T. F. Blyth, G. R. Boyer,

W. H. Buttrey, H. A. Cannon, J. W. Carson, H. Dessen, L. H. Dixon, N. V. Drury, N. D. H. Evans, A. Farrell, J. N. Fenton, E. D. Ferguson, Nora M. Foulds, I. B. Frankel, John Funk, C. F. Gaviller, T. G. Gedge, J. Ginsberg, J. J. Gotlieb, J. M. Griffith, E. J. Guignard, F. T. Hoare, V. E. Hopps, L. E. Jess, G. P. Kemp, R. A. Lachance, K. T. N. Lapp, S. Lerner, J. M. Lumby, J. V. MacMurchy, H. Magder, G. D. Mathewson, H. C. Middleton, E. J. Mitchard, W. L. Moran, Gladys I. Morrow, D. M. Murton, J. S. Murton, W. C. McDonald, D. O. McLean, A. R. McRae, L. E. Newth, P. R. Peacock, M. Rabinowitz, L. C. Reise, H. R. Sanders, G. N. Saunders, W. R. Scott, G. H. Smith, E. Stead, Helen E. Stowe, J. C. Sutherland, A. S. Tanner, G. B. Taylor, G. A. D. Telfer, R. J. Thompson, J. N. Thomson, W. A. Turner, H. F. Vearncombe, R. B. Vopni, K. L. Welch, W. N. Willoughby, F. S. Wilson, W. B. Winberg and K. F. Wormald.

Intermediate: Claude Abrams, Joseph Ages, G. R. Barrett, F. C. C. Boland, D. K. Cameron, A. Campbell, J. E. Copland, J. A. Cross, Roy Curtis, E. B. Daubney, M. Beryl Farmer, H. A. Ford, F. W. Fromm, W. F. Harvie, E. D. Hill, J. K. Hill, C. R. Jolly, R. E. F. Jones, F. D. Kemp, R. C. Kilgour, J. R. Lussier, A. D. Mackay, K. D. MacLennan, J. Magder, S. Marks, C. J. Nickleson, W. R. Ofield, W. Omand, K. R. Oswell, L. G. Sayers, J. G. Sheldrick, J. E. Smyth, S. S. Spiegel, Margaret J. Trench, R. A. Woolsley and G. R. Yule.

Final: The following having passed the respective examinations and completed the Institute's requirements regarding service and instruction have now been elected to membership by the Council: K. W. Ball, G. K. Carr, A. W. Coome, J. K. Ferguson, F. W. Fredenburg, D. R. Gormley, J. E. Hall, W. D. Howison, W. T. D. Lake, E. A. Leftly, R. W. Meanwell, S. R. Nicholson, G. S. Pover, E. B. Richards, T. R. Roden, H. V. E. Slaney and Max Stern.

In addition T. F. Burton and P. C. Metherell passed all the papers of the final examination and upon completion of the required service and instruction will be eligible for election to membership.

Supplemental Examinations: The following passed in all but the subjects indicated in the final examination and have been granted supplemental examinations therein: D. H. Beattie (Auditing), J. T. Bowles (Accounting III & IV),

T. R. Caldwell (all Accounting papers and Economics), D. S. Chant (Auditing), W. J. H. Coggins (Accounting I & IV), D. A. Colquhoun (all Accounting papers and Economics), J. Duncanson (Economics), J. W. Glendinning (Accounting II & IV), W. J. Hudson (all Accounting papers), C. H. Hunt (Auditing), J. B. Kearney (all Accounting papers), J. H. Kew (Accounting I & II), J. S. Lang (Auditing), R. E. A. Lindsey (Auditing), I. G. Milne (Auditing), D. T. Myers (Auditing), R. T. McGraw (Economics), H. S. McLellan (Accounting I & III), L. I. Papoff (all Accounting papers), M. M. Robertson (Economics), A. Shulman (all Accounting papers), J. J. Stone (all Accounting papers), J. C. Tinkham (all Accounting papers), C. R. Welch (Accounting II & III), G. R. Wildblood (all Accounting papers) and C. F. Wilson (Economics and Auditing).

Prizes—The Institute announces the following prize winners:

Final: Gold Medal—R. W. Meanwell, Windsor; George Edwards Prize—E. B. Richards, Toronto; W. T. Kernahan Prize—W. D. Howison, Toronto; E. R. C. Clarkson Gold Medal—T. F. Burton, Toronto.

Intermediate: First Prize—F. W. Fromm, Toronto; Second Prize—J. A. Cross, Ottawa.

Primary: First Prize—J. S. Murton, Toronto; Second Prize, M. Rabinowitz, Toronto.

PRINCE EDWARD ISLAND

The Institute of Chartered Accountants of Prince Edward Island announces that Neil W. Higgins was successful in the December 1942 uniform final examination of the provincial Institutes of Chartered Accountants.

QUEBEC

The Society of Chartered Accountants of the Province of Quebec announce the following results in the examinations conducted by the Board of Examiners-in-Chief of the provincial Institutes of Chartered Accountants 30th November to 5th December 1942:

Intermediate—Passed: James Aitken, A. W. Bell, C. F. P. Flaman, B. Garmaise, Marius Laliberte, J. A. MacDonald, F. M. Sadler, H. Silver, W. Weiner and M. A. Yale.

Final—Passed full examination: Roland Bedard, D. S. Dubin, S. F. Finesilver, E. R. Graham, A. Gordon Hall, A. K. Lamplough, B. G. Levine and J. Leznoff.

Passed supplemental examination: G. Baribeau, W. E. Evens, D. Finestone, Wm. Hashim, W. J. S. McEntee, C. G. O'Neill, M. Prupas, P. H. Simard, C. Frank Topp and Paul Trudel.

Granted supplemental examination: K. J. Bielby, F. Knowles, W. A. Lyster, H. Pesner and A. C. Rooney.

Prizes—Intermediate: Winner of War Memorial Prize, Marius Laliberte, a graduate of L'Ecole Superieure de Commerce de Quebec, who also won the first prize awarded by the Dominion Association for obtaining highest marks in the Dominion.

Final: Winners of War Memorial Prizes, S. F. Finesilver, first prize; he also won the second prize awarded by the Dominion Association; J. Leznoff, second prize. Both of these prize winners are serving in the Royal Canadian Air Force.

Candidates of L'Ecole des Hautes Etudes Commerciales de Montreal:

The following students passed the final examination held 23rd November to 26th November 1942 at L'Ecole des Hautes Etudes Commerciales de Montreal, set under the provisions of Act 17, George V, Chapter 46 and the agreement between the School and the Society:

Final—Passed full examination: Roger Gauvin, J. D. de Varennes, Eddy McNeil, Paul Murray, Roger Roy, Maurice Salvas, J. Turcot and Paul Verner.

Passed supplemental examination: A. Lanctot, J. Morisset, J. Ostiguy and Philippe St. Jacques.

SASKATCHEWAN

The Institute of Chartered Accountants of Saskatchewan announces that the following are the successful candidates in the uniform examinations of the provincial Institutes in December 1942:

Final: Peter Fabris, B.Acc., and T. G. N. Hunter.

Granted supplemental examination: L. J. Shuler, B.Acc., (Accounting II & III).

Final Part I: Nairn C. Hagan.

CHARTERED ACCOUNTANTS' CLUB OF OTTAWA

AS a result of the war, a large number of chartered accountants from all parts of the Dominion have moved to Ottawa where they are employed in various government departments and agencies. These men, together with those already engaged in private practice or otherwise employed in Ottawa, have long felt the need of an organization which would enable the members of the various provincial Institutes to meet, the purpose of such meetings being to exchange views and ideas on topics of current interest and also to foster a spirit of understanding and good fellowship among the members of the profession.

The chartered accountants resident in Ottawa recently formed an organization to be known as The Chartered Accountants' Club of Ottawa. The aims and objects of the club are, briefly:

1. To encourage the development of and adherence to high professional standards and sound ethical practices.

2. To promote fellowship and understanding among members through: (a) the discussion of matters of mutual and current interest; (b) social gatherings; (c) the encouragement of student activities.

The following members constitute the executive committee of the club: President, A. O. Adamson; vice-president, B. A. Armstrong; secretary, J. E. Clubb; treasurer, L. E. Lugsdin; conveners, program committee, J. A. Robson and J. C. McCay; constitution and by-laws committee, R. H. Bounsall; publicity committee, N. Johnson.

OBITUARIES

The Late Georges Gonthier

The Society of Chartered Accountants of the Province of Quebec records with deep regret the death of Georges Gonthier, former auditor general of Canada, a member since 21st March 1922.

The late Mr. Gonthier practised as a public accountant from 1892 and in 1907 entered into partnership with Alfred St. Cyr and Albert P. Frigon, bankers and brokers. In 1911 he formed a partnership with H. E. Midgley, chartered

accountant, and from 1924 to 1939 held the position of auditor general of Canada. Mr. Gonthier was treasurer of the Montreal Chamber of Commerce from 1910 to 1914, a member of the first executive of the Investment Bankers' Association of Canada, member of the Conseil de Patronage de L'Ecole des Hautes Etudes Commerciales, and a life governor of Notre Dame Hospital. He was commissioner censor of Credit Foncier Franco-Canadien from 1918 to 1924 and chairman of the board of audit of the Dominion government in 1924-25.

Mr. Gonthier received the degree of Doctor of Commercial Sciences of the University of Montreal (honoris causa) in 1934, the LL.D. degree (honoris causa) of the University of Ottawa in 1935, being awarded the King George V. Jubilee Medal the same year and Their Majesty's Coronation Medal in 1937.

To his widow and family the members of the Society extend their sincere sympathy.

The Late William Robertson

The Institute of Chartered Accountants of Alberta regrets to announce the death of William Robertson on 19th January 1943.

Mr. Robertson became a member of the Alberta Institute in 1915 and served on the Council during 1926 and 1927.

He is survived by his wife, one daughter, and one son at present serving overseas, to all of whom the Institute extends sincere sympathy.

The Late George Percy Blythe

The Institute of Chartered Accountants of Alberta regrets to announce the death of George Percy Blythe, which occurred some time ago and has only recently been known to the Institute.

Mr. Blythe was the first President of the Institute serving in that capacity in 1910-1911 after admission to membership by the Act of Incorporation in December 1910. He was elected a Fellow in 1912. In 1933 he resigned his active membership and was elected an Honorary Member.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

To all those who were successful in the recent examinations and particularly to the finalists the Students' Department extends, on behalf of its readers, hearty congratulations and sincere good wishes for future success. That the winner of the Dominion Gold Medal should have attained this distinction while he was already preoccupied with military duties entitles him to a very special measure of congratulation. We wish him happy fortune in the service and an early return to his chosen profession.

* * *

Two months ago we made some comments on Professor Ashley's new book, "Introduction to Accounting for Students of Economics." At the risk of receiving a writ for trespass from our colleagues in the "Glimpses" and book review sections of the magazine we draw our readers' attention this month to another book directed at others than accountants, namely, "Introduction to Engineering Economy" by Woods and DeGarmo.[1] Although written, as its title indicates, for the enlightenment of students in applied science it contains much that would be valuable background knowledge for any industrial accountant. For purposes of this note we confine our comment to Chapter XII entitled, "Fixed, Differential and Sunk Costs," for this contains what every text on cost accounting should contain but few do, a simple exposition of the nature of differential costs and a demonstration of the serious errors into which management may fall if it bases on the accountant's average unit costs judgments which should be based on differential costs. The judgments of this kind which the authors discuss and illustrate are those on such questions as whether a concern engaged in the manufacture of an assembled product should itself manufacture all parts or should buy certain parts from other manufacturers, whether new products should be produced, whether by-products should be pro-

[1] Baldwin M. Woods and E. Paul DeGarmo, *Introduction to Engineering Economy*, (Macmillan, New York, 1942) pp. 441. $4.00.

cessed, whether there would be an economy in a temporary shut-down of plant, and whether excess capacity should be utilized by dumping. We recommend the whole book to all of our readers but we especially recommend Chapter XII to those who are interested in the practical and intelligent application of cost data to the solution of problems of management.

* * *

Advanced texts in accounting usually explain and illustrate the "annuity" method of computing periodic depreciation but then dismiss it as impractical and misleading. This attitude may be quite sound provided it is restricted to the use of the method by an established concern which has already sunk its capital in fixed assets. But the usual text treatment tends to obscure the fact that the annuity method, by including interest as a cost, is the most useful and practical of all methods to employ when debating *whether or not* to sink capital in the purchase of a certain fixed asset or prosecution of a certain enterprise. A simple illustration will help to make this point. Suppose a business is confronted with a choice between a machine costing $5,000 having a life of five years and a machine costing $10,000 having a life of ten years. The straight line method of computing depreciation indicates that the annual cost will be identical for both machines, viz., $1,000. The annuity method (taking interest at 6 per cent) reveals that the annual cost of the short lived machine will be $1,187, of the long lived machine $1,359, or that over ten years the interest saving by the less durable machine will amount to $1,720 (13,590-11,870). This means that a decision to install the longer lived machine would swallow up quite unnecessarily capital which, but for that decision, could have been invested to bring in $1,720 of cash income. It is therefore a real cost of such a decision.

* * *

STUDENTS' NOTES

Province of Quebec

Posthumous Honour Given Flight-Sergeant M. L. Usher

Flight-Sergeant M. L. Usher, R.C.A.F., a member of the Chartered Accountants Students' Society of the Province of Quebec, who was killed in action overseas and buried in the Shetland Islands last April, has been posthumously commissioned pilot officer, retroactive to 25th October 1941 ac-

cording to word received by his parents from R. C. A. F. headquarters in Ottawa.

R. C. A. F. officials here have informed his family that the commission awarded posthumously is a signal honour and must be in recognition of some exceptional service. We are proud of Pilot Officer Usher, and grateful for his sacrifice.

* * *

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

FINAL EXAMINATION, DECEMBER 1942

Accounting I, Question 1 (25 marks)

You are asked by an investment dealer to verify the balance sheet of the Creaky Furniture Manufacturing Company Limited as at 31st October 1942 and to report on its earnings for the five years ended on that date. The accounts have been audited by a chartered accountant for the period but you are requested to make your examination sufficiently extensive to enable you to give an unqualified opinion as to earnings for inclusion in a prospectus.

Outline the work you would do in order to be able to give such an opinion as to earnings *in addition to* your examination of the balance sheet at 31st October 1942.

SOLUTION

(1) Obtain a copy of the underwriting agreement and compute what the effect of the financing will be on the earning (as well as on the balance sheet) position. Make careful enquiries as to changes, if any, in personnel, policies, etc., which will result and consider whether these are such as to affect materially the earnings.

(2) Study carefully the auditors' reports for the years 1937 to 1942 inclusive.

(3) Spread profit and loss statements for *six* years to 31st October 1942.

(4) Spread audited balance sheets at 31st October each year from 1937 to 1942 inclusive.

(5) Check profit and loss and balance sheets against the company's books.

(6) Enquire into unusual variations from year to year.

(7) Examine tax returns and assessments for the period and ascertain the standard profits of the company.

(8) Examine the minute books for the period, letters patent, etc.

(9) As, in the absence of a detailed audit, earnings can be most easily confirmed by analysis of the unexpired debits and credits carried forward to the balance sheet each year, enquire carefully into the following:

Accounts receivable—Are sales cut off exactly on 31st October each year, or has the date varied from year to year?

Reserve for bad debts—Was the reserve adequate at the beginning of the period and were the annual provisions fair charges against each year's operations? This can be established by analyzing write-offs during the period and the reserve required at 31st October 1942 by the year in which sales were made.

Inventories—Are variations in gross profit from year to year reasonable?

—If book inventories are kept, have overages and shortages at the year-ends been small and/or consistent?

—Is there a good system of internal check on establishing inventory quantities and has it been in effect throughout the period?

—Has the company carried out a consistent policy in pricing its inventory from year to year? Tests should be made to establish that concepts of cost and market have not altered.

Fixed assets—Examine vouchers covering larger additions throughout the period.

—Scrutinize maintenance and repair accounts to establish that a proper and consistent policy has been followed.

—Verify the provision for depreciation each year throughout the period and satisfy yourself that the rates used are reasonable and are consistently applied.

—Satisfy yourself that disposals are promptly eliminated from the accounts.

—Analyze reserves for depreciation throughout the period, noting any unusual items.

Prepaid expenses and deferred charges—Satisfy yourself that the policy of prepaying expenses has been consistent from year to year.

Accounts payable and accrued charges—Make sure that a consistent policy has been followed in accruing expenses.

—Test October and November purchase and expense entries in each year to satisfy yourself that they were entered in the proper fiscal year.

Taxes on income payable—As income and excess profits tax provisions will be computed at present rates it is not necessary to establish their accuracy from year to year. It will be necessary to analyze the accounts for the period to establish that only the provisions shown in the profit and loss statements were credited and only income and excess profits taxes paid were charged.

Reserves (other than bad debt and depreciation)—Analyze and establish that provisions charged against profit and loss were necessary and properly chargeable to the year in which they were provided and that charges against the reserves properly relate to the provisions.

Surplus—Analyze and charge any items applicable to prior years' earnings against the proper year.

Executive salaries, interest paid, investment income, profit and loss on fixed assets, miscellaneous income—Analyze and consider carefully any unusual items therein.

PROBLEM II

FINAL EXAMINATION, DECEMBER 1942

Accounting I, Question 2 (20 marks)

Your firm has just completed an investigation of a business and you are requested by the partner in charge of this work to prepare a statement showing the source and application of funds during the year ended 30th June 1942 which he wishes to incorporate in his report. The following figures are handed to you:

BALANCE SHEET

Assets

	30th June 1942	30th June 1941
Cash on hand and in bank	$ 2,175	$ 45,227
Accounts receivable	163,723	129,364
Life insurance, cash surrender value	12,900	10,400
Inventories	736,382	403,297
Shares in and advances to subsidiary company	262,372	196,785
Fixed assets—at cost	593,629	502,733
Prepaid expenses	9,563	10,721
Patents, less amounts written off	16,575	18,750
Bond discount, less amounts written off	7,500	8,950
Organization expense	......	875
	$1,804,819	$1,327,102

Liabilities

	30th June 1942	30th June 1941
Bank loan	$ 79,318	......
Accounts payable and accrued charges	102,397	$ 78,624
Reserve for income and other taxes	225,000	65,000
Reserve for bad debts	8,500	7,100
Reserve for inventories	50,000	25,000
Reserve for depreciation	218,053	198,327
Bonds payable	275,000	300,000
Capital stock (par value $100 per share)	500,000	400,000
Earned surplus	346,551	253,051
	$1,804,819	$1,327,102

SUMMARY PROFIT AND LOSS ACCOUNT

Year ended 30th June 1942

Net profit before the following charges		$ 486,768
Deduct:		
Bond and bank interest	$ 20,372	
Bond discount written off	1,450	
Provision for bad debts	2,763	
Provision for depreciation	36,923	
Amortisation of patents	2,675	
Life insurance expense	3,673	
Organization expense written off	875	
	$ 68,731	
Less profit on sale of fully depreciated fixed assets (original cost $17,197)	3,463	
		65,268

Net profit before taxes on income and provision for inventory reserve		$ 421,500
Deduct:		
Provision for future decline in inventory value	$ 25,000	
Provision for income and excess profits taxes	223,000	
		248,000
Net profit for year		$ 173,500

On 23rd October 1941 the directors of the company declared a 10% cash dividend together with a bonus stock dividend of the same amount, the shares being issued at par.

SOLUTION

STATEMENT OF WORKING CAPITAL

	30th June 1942	30 th June 1941	Increase or *decrease*
Current assets and prepaid expenses:			
Cash on hand and in bank	$ 2,175	$ 45,227	*$ 43,052*
Accounts receivable less reserve	155,223	122,264	32,959
Life insurance—c.s.v.	12,900	10,400	2,500
Inventories less reserve	686,382	378,297	308,085
Prepaid expenses	9,563	10,721	*1,158*
	$866,243	$566,909	$299,334
Current liabilities:			
Bank loan	$ 79,318		$ 79,318
Accounts payable and accrued charges	102,397	$ 78,624	23,773
Reserve for income and other taxes	225,000	65,000	160,000
	$406,715	$143,624	$263,091
Working capital	$459,528	$423,285	$ 36,243

STATEMENT OF FUNDS

The increase of $36,243 is attributable to—

1. From operations:			
Net profit for year	$173,500		
Add charges thereagainst which did not reduce working capital:			
Depreciation	36,923		
Bond discount	1,450		
Organization expense	875		
Amortization of patents	2,675	$215,423	
2. Proceeds of sale of capital stock		60,000	$275,423
Which was offset in part by:			
1. Additions to fixed assets		$108,093	
2. Patents acquired		500	
3. Advances to subsidiary		65,587	

4. Dividend paid	40,000		
5. Bonds redeemed	25,000	239,180	
A net increase (as above) of			$ 36,243

Calculations

(1) *Balance sheet differences*:

Net current assets	+ $ 36,243	Bonds payable	— $ 25,000
Investments in subsidiary companies	+ 65,587	Capital stock	+ 100,000
Fixed assets (net of reserve)	+ 71,170	Earned surplus	+ 93,500
Patents	— 2,175		
Organization expense	— 875		
Bond discount	— 1,450		
	+ $168,500		+ $168,500

(2) *Purchase of fixed assets*:

Balance sheet difference (net of reserve)	+ $ 71,170
Add: Depreciation charged	+ 36,923
	$108,093

(3) *Purchase of patents*:

Balance sheet difference	— $ 2,175
Add: Amortization	+ 2,675
	$ 500

PROBLEM III

FINAL EXAMINATION, DECEMBER 1942

Accounting I, Question 3 (20 marks)

Local Broadcasters Limited, who operate a radio station, have applied to their bankers for a loan of $5,000, explaining that their present financial difficulties are due to heavy capital expenditures on new and greatly improved equipment which will substantially increase their operating income. They present the following unaudited balance sheet as at 30th June 1942:

Assets		Liabilities	
Accounts receivable	$ 5,700	Bank overdraft	$ 300
Supplies and spare parts	5,000	Accounts payable	6,500
Land—at cost	5,000	Taxes payable	6,920
Buildings—at cost	20,000	Reserve for depreciation	12,000
Equipment—at cost	29,500	Capital	10,000
		Surplus	29,480
	$65,200		$65,200

You are asked by the bank to verify the above balance sheet and obtain such other information as may be helpful to them in making their decision. Your investigation discloses:

(1) The company owes $10,000 on lien notes for equipment, payable in twenty equal monthly instalments. Neither the debt nor the corresponding debit to the asset account has been in-

cluded in the above balance sheet.

(2) Earnings for the year ended 30th June 1942, before taxes on income, were $12,000. Provision for taxes was $6,920 which seems correct.

(3) The company's standard profits have been established at $5,000, a submission for a higher standard having been rejected.

(4) Accounts payable include overdue trade accounts aggregating $1,000 and a loan from a director of $5,000.

(5) The equipment is modern, the management seems aggressive and it seems quite likely that their expectation of increased operating income will be realized.

Draft the sections of your report to the bank dealing with (a) factors the bank should take into account in considering whether it will make the loan, and (b) safeguards which should be insisted on if the loan is made.

SOLUTION

SECTIONS OF REPORT TO BANK

Factors to be considered

(1) The company's cash requirements are likely to be more than the amount of the loan of $5,000 requested. The following liabilities are now due:

Taxes payable	$6,920
Overdue accounts payable	1,000
Bank overdraft	300
	$8,220

If the bank is to make any loan it should be sufficient to enable the company to meet its current obligations without difficulty.

(2) The security which the bank can obtain, unless it is possible to get guarantees from the directors of the company, is limited to trade accounts receivable of $5,700. The inventory is not held for resale and accordingly does not measure up to the bank's usual standards of collateral.

(3) The company can only hope to repay this loan out of future earnings. By reason of the new rates of excess profits tax the company's future earnings will be limited to 70% of its standard profits or $3,500. In addition the company will have credited to it 20% of earnings above $5,833, to be repaid after the war but this will not be available for several years at the earliest. During the next fiscal year the company can only expect to have funds available from earnings equal to

ings equal to		$3,500
plus the depreciation charged against earnings which is estimated as follows:		
Buildings—$20,000 @ 2½%	$ 500	
Equipment—$39,500 @ 10%	3,950	4,450
A total of		$7,950
Against this the company must be prepared to meet the current obligations referred to above of	$8,220	
and lien notes payable for equipment totalling	6,000	

a total of	14,220
At the end of the year the company is, therefore, going to require a loan of	$6,270
less the unpaid tax on that year's income	

It will be seen from the above that it will be two years before the company can hope to repay this loan out of earnings if taxes stay at present levels even if no further capital expenditures are made, the loan from the director remains unpaid and no dividends are declared.

Safeguards—If the bank should make this loan we think the following safeguards should be insisted on in addition to obtaining whatever security is possible:

(1) The director should subrogate his claim in favour of the bank and agree not to accept repayment while the loan from the bank is outstanding.

(2) The company should agree not to make any capital expenditures without the prior approval of the bank.

(3) The company should also agree not to pay any dividends while the loan is outstanding.

(4) The company should provide the bank with a budget for the year on a monthly basis and also monthly statements showing a comparison of its actual and budgeted operations and cash position.

PROBLEM IV

FINAL EXAMINATION, DECEMBER 1942

Accounting I, Question 4 (15 marks)

The ABC Company is considering the purchase of all the outstanding shares of the XYZ Company, primarily to ensure a guaranteed source of supply for its most vital raw material. You were asked to make an investigation of the accounts of the latter company and you have discovered that the company's operating statements and balance sheets to 30th June 1939 were reasonably accurate, but that after that time, in order to justify dividends, profits were definitely overstated.

The profits *before tax* as stated by the company were:

Year ended 30th June 1940	$ 95,000
Year ended 30th June 1941	120,000
Year ended 30th June 1942	100,000

Your investigation disclosed that:

At 30th June 1940,—

The company's own goods in branch inventories amounted to $150,000, which was 20% in excess of cost.

The following liabilities were omitted from the books:

Goods on hand (also omitted from inventory)	$10,000
Accrued wages	3,500
Sundry accrued charges	2,000

The bad debt reserve should have been increased by $8,000.

Depreciation of $15,000 had been provided on the books and your calculations show that $25,000 should have been provided.

At 30th June 1941,—

The company's own goods in branch inventories amounted to $200,000, which was 25% in excess of cost.

The following liabilities were omitted from the books:

Construction in progress	$20,000
Material included in inventory	5,000
Accrued wages	3,000
Sundry accrued charges	1,000

The bad debt reserve should have been increased by $12,000.

Furniture and fixtures costing $5,000 had been charged to expense.

Due to a clerical error the inventory was overstated by $12,000.

No provision was made for depreciation on the company's books, and after taking the $5,000 mentioned above into consideration your calculations show that $30,000 should have been provided.

At 30th June 1942,—

The company's own goods in branch inventories amounted to $195,000, which was 30% in excess of cost.

The following liabilities were omitted from the books:

Purchase price of new machinery	$15,000
Accrued wages	3,300
Sundry accrued charges	1,500

The bad debt reserve should be increased by $10,000.

The profits for the year include $5,000 damages received because of faulty materials purchased during the year ended 30th June 1940.

Depreciation provided on the books amounted to $20,000; your calculations show that $33,000 should have been provided.

Required:

Prepare a reconciliation of the profits before tax of the XYZ Company for 1940, 1941 and 1942 as shown by the books with the adjusted figures before tax to be submitted to the ABC Company.

SOLUTION

XYZ COMPANY LIMITED

STATEMENT OF EARNINGS ADJUSTMENTS

Adjustments	1940	1941	1942
Branch inventories—1940	*$ 25,000*	$ 25,000	
1941		*40,000*	$ 40,000
1942			*45,000*
Liabilities —1940	*5,500*	5,500	
1941		*9,000*	9,000
1942			*4,800*
Bad debts	*8,000*	*4,000*	2,000
Depreciation	*10,000*	*30,000*	*13,000*
Furniture and fixtures charged in error		5,000	
Inventory error		*12,000*	12,000
Damages recovered	5,000		*5,000*
	$ 43,500	*$ 59,500*	*$ 4,800*
Profits as stated	95,000	120,000	100,000
Adjusted profits	$ 51,500	$ 60,500	$ 95,200

PROBLEM V

FINAL EXAMINATION, DECEMBER 1942

Accounting I, Question 5 (20 marks)

You have been requested by the Council of the Town of Blank to investigate an unaccounted for decline in the revenues of their waterworks department.

The water is metered and the installations, meter-reading and billing are handled by the waterworks department. Meter readers are permitted to accept payment of accounts (which they compute at the time of reading) and payments so received are noted on the bill which is mailed to the consumer in the ordinary course. At the end of each day the waterworks department turns over to the treasurer's department duplicates of the bills issued that day and a list showing for each bill,

(1) Name and address of consumer

(2) Amount billed

(3) Payments collected by meter readers.

Cash is turned over equal to the total of column (3). A 5% discount is allowed for payment within two weeks.

You satisfy yourself that there is an excellent control on cash received by the treasurer's department.

Required:

What steps would you take to establish that the lists turned over to the treasurer's department show the full amount of revenue which the town should receive from the sale of water?

SOLUTION

In approaching this problem three questions suggest themselves: Are there any omissions, i.e. are all services being billed? Are there any errors in computation, i.e. are the amounts being billed correct? Is there any withholding, i.e. are bills being issued promptly and are payments collected by meter readers being turned over to the Treasurer's Department immediately after collection?

Omissions.

The following should be followed up:

(1) Are all services being metered? This may be checked by comparing the assessment roll of occupied houses with the record of meters installed.

(2) Are all meters being read? This may be confirmed by comparing the record of meters installed with meter readers' books and might be done in the same operation as (1) above.

(3) Is there any check that the meters are being read correctly? It might be possible for a meter reader to consistently and cumulatively reduce the total meter reading. The most satisfactory check on this would be for a rotation of meter readers and if this has been the practice in the past it would probably not be necessary to investigate this phase further.

(4) Are bills being made covering every meter reading? This would be checked by comparing the meter readers' books with the duplicate of the bills issued.

Errors in computation.

(1) A thorough check should be made of the rates being charged and the calculations, both those made by the meter readers in determining the customer's debt at the time of reading and those made in the office.

(2) Is the consumption being correctly computed? An extensive clerical test should be made of this.

(3) Is the discount being allowed only when payment is made within the two weeks?

Withholding.

At the same time that the meter readers' books are being compared with the duplicate bills the date of reading and the date of billing should be compared and also the date on which this was reported to the treasurer. Any undue lag between the first and the second should be thoroughly investigated and there should be no time lag at all between the second and third.

Internal check.

Obviously the internal check in existence will determine the extent of the tests. If there appears to be an adequate system of internal check it will only be necessary to make sufficient tests to confirm that the check is actually there. The inquiry into internal check should also extend to a consideration of overall tie-ups of total consumption as read by meter readers with bills issued.

A further overall check might be made by comparing billings by districts from period to period with those of the preceding year and the total billings for each month with the pumping stations record of water put into the mains. In doing this, however, allowance will have to be made for the time lag between the date of consumption and the date of billing and for leakages.

TAX BOOKLET

The Society of Chartered Accountants of the Province of Quebec announces that there are still a few copies of the fifty page booklet entitled "Notes on the Dominion of Canada Income War Tax Act, The Excess Profits Tax Act, and the Wartime Salaries Order" prepared by Mr. A. W. Gilmour, chartered accountant, of the Department of National Revenue, Income Tax Division, Montreal. Copies may be obtained by mailing twenty-five cents in stamps or a postal note to the Society's offices, 430 Canada Cement Building, Montreal.